HEARING

STATE OF CALIFORNIA

DEPARTMENT OF FOOD AND AGRICULTURE

AMENDMENTS TO THE POOLING PLAN FOR MARKET MILK AND THE STABILIZATION AND MARKETING PLANS FOR MARKET MILK FOR THE NORTHERN CALIFORNIA AND SOUTHERN CALIFORNIA MARKETING AREAS

HOLIDAY INN HOTEL

CALIFORNIA ROOM

300 J STREET

SACRAMENTO, CALIFORNIA

WEDNESDAY, JUNE 4, 2003

9:00 A.M.

JAMES F. PETERS, CSR, RPR
CERTIFIED SHORTHAND REPORTER
LICENSE NUMBER 10063

PETERS SHORTHAND REPORTING CORPORATION (916) 362-2345

APPEARANCES

DEPARTMENT PANEL MEMBERS

Richard Estes, Hearing Officer
California Department of Food and Agriculture

Eric M. Erba, Senior Agriculture Economist
Dairy Marketing Branch
California Department of Food and Agriculture

Thomas W. Gossard, Agriculture Economist
Dairy, Marketing Branch
California Department of Food and Agriculture

David Ikari, Chief
Dairy Marketing Branch
California Department of Food and Agriculture

John Lee, Chief, Milk Pooling Branch
California Department of Food and Agriculture

Donald Shippelhoute, Research Manager
Milk Pooling Branch
California Department of Food and Agriculture

INDEX

PROCEEDINGS

HEARING OFFICER ESTES: Good morning. This hearing will come to order.

The California Department of Food and Agriculture calls this public hearing to be held in the California Room at the Holiday Inn, Capitol Plaza, 300 J Street, Sacramento, California on this date June 4, 2003 beginning at 9:00 a.m.

On March 10th, 2003, the Department of received a petition from Land O' Lakes requesting amendments to the transportation allowance and transportation credit system in the Pooling Plan and Stab Plans.

On April 28th, 2003, Milk Producers Council submitted an alternative proposal.

Accordingly, the purpose of this hearing is to consider amendments to the transportation allowance and transportation credit system to the Pooling Plan and Stabilization Plan.

The proposals to the Pooling and Stabilization plans that provide incentives to move milk to higher usages may also be considered.

My name is Richard Estes and I've been designated as the Hearing Officer for today's proceedings. Testimony and evidence pertinent to the call of the hearing will be received. Anyone wishing to testify must sign the hearing witness roster located at sign-in table. I imagine most of you here today are familiar with that process.

Oral testimony will be received under oath or affirmation. Staff available at the back of the room to provide assistance are Ed Hunter Supervising Auditor, Candice Yates, Research Manager, and Carry Dapper Research Program Specialist.

Please note that only those individuals who have testified under oath during the conduct of the hearing may request a post-hearing briefing period to amplify, explain or withdraw their testimony.

Only those individuals who have successfully requested a post-hearing briefing period may file a post-hearing brief with the Department.

The hearing panel has been selected by the Department to hear testimony, receive evidence, question witnesses and make recommendations to the Secretary. Please note that the questioning of witnesses by anyone other than members of the panel is not permitted.

The Panel is composed of members of the Department's Dairy Marketing Branch. And I think in this instance we actually have Milk Pooling Branch. So in this instance we have people from both the Dairy Marketing Branch and the Milk Pooling Branch.

We have David Ikari, Chief, Dairy Market Branch;

John Lee, Chief of the Milk Pooling Branch; Tom Gossard, Senior Agricultural Economist; Dr. Eric Erba, Senior Agricultural Economist; and Donald Shippelhoute, Research Manager. Clearly, they are the people seated next to me here today up here on podium.

I am not a member of the panel. And I will not be taking part in any decisions relative to the hearing. The hearing reporter here today is James Peters of the firm Peters Shorthand located here in Sacramento. A transcript of today's hearing will be available for review at the Marketing Branch Headquarters located in Sacramento at 1220 N Street. Here I have room A-247, but that's -- I guess it still would be room A-247. They moved a bunch us from one building to another, but I think the analysts -- there's no problem with that.

Anyone desiring copies of the transcript from today's hearing must purchase them from Peters Shorthand.

Now, we will proceed to have the exhibits introduced by the Department witness. At this time, Cheryl Gilbertson, analyst, Dairy Marketing Branch will introduce them.

(Thereupon the witness was sworn, by the Hearing Officer, to tell the truth and nothing but the truth.)

STAFF ANALYST GILBERTSON: I do.

HEARING OFFICER ESTES: And would you please present your exhibits.

STAFF ANALYST GILBERTSON: Mr. Hearing Officer, my name is Cheryl Gilbertson. I am an analyst with the Dairy Marketing Branch of the California Department of Food and Agriculture. My purpose here this morning is to introduce the Department's hearing exhibits numbers 1 through 56. With these exhibits, previous issues of exhibits 20 through 56 are also hereby entered by reference.

The exhibits being entered today have been available for review at the office of the Dairy Marketing Branch, since the close of business on May 28th, 2003.

An abridged copy of the exhibits is available for inspection at the back of the room. Multiple copies of Exhibits 1, 4, 5 and 6 are also available at the back of the room.

I ask, at this time, that the composite exhibits be received.

HEARING OFFICER ESTES: If you please present them and I will mark them for acceptance into the record. The Department's exhibits will be identified as composite exhibits 1 through 56. And I will stamp them at the time you introduce them into the record.

(Thereupon the above-referenced documents

were marked, by the Hearing Officer, as
Exhibits 1 through 56.)

HEARING OFFICER ESTES: Does the panel have any questions concerning the exhibits?

All right. Does anyone in the audience have any questions regarding the content of the Department's exhibits?

Do you have additional exhibits, I'm sorry.

STAFF ANALYST GILBERTSON: The exhibit next in order is a letter dated May 27th, 2003 from the Imperial County Board of Supervisors signed by Joe Maruca, Chairman, as Exhibit 57.

HEARING OFFICER ESTES: It will be entered into the record as Exhibit number 57.

(Thereupon the above-referenced document
was marked, by the Hearing Officer, as
Exhibit 57.)

STAFF ANALYST GILBERTSON: The exhibit next in order is a letter dated May 27th, 2003 from Nudairy One signed by Ed McGrew.

HEARING OFFICER ESTES: It will be introduced into the record as Exhibit number 58.

(Thereupon the above-referenced document
was marked, by the Hearing Officer, as
Exhibit 58.)

STAFF ANALYST GILBERTSON: The exhibit next in order is a letter Dated May 30th, 2003 from Robert Horton as Exhibit 59.

HEARING OFFICER ESTES: The letter will be introduced into the record as Exhibit 59.

(Thereupon the above-referenced document was marked, by the Hearing Officer, as Exhibit 59.)

STAFF ANALYST GILBERTSON: The exhibit next in order is a letter dated May 30th 2003 from Santee Dairies Incorporated, signed by Paul W. Bikowitz, President as Exhibit 60.

HEARING OFFICER ESTES: The letter will be introduced into the record as Exhibit 60.

(Thereupon the above-referenced document was marked, by the Hearing Officer, as Exhibit 60.)

STAFF ANALYST GILBERTSON: The exhibit next in order is a letter dated June 3rd, 2003 from Imperial County Agricultural Commissioner's Office, signed by Stephen L. Birdsall, Agricultural Commissioner as Exhibit 61.

HEARING OFFICER ESTES: This will be introduced into the record as Exhibit number 61.

(Thereupon the above-referenced document

was marked, by the Hearing Officer, as
Exhibit 61.)

STAFF ANALYST GILBERTSON: The exhibit next in order is written testimony of Gary M. Stueve on behalf of Dairy Marketing Services, LLC as Exhibit 62.

HEARING OFFICER ESTES: And it will be introduced into the record as Exhibit 62.

(Thereupon the above-referenced document
was marked, by the Hearing Officer, as
Exhibit 62.)

STAFF ANALYST GILBERTSON: There are copies of these documents at the back of the room. I ask that these documents and statements be received as Exhibits 57 through 62.

Mr. Hearing Officer, this concludes my testimony.

HEARING OFFICER ESTES: Thank you very much.

Again, I'll give the panel an opportunity to make any inquires they wish to make about the exhibits that were introduced into the record here today.

Seeing none, does anyone in the audience have any questions regarding the content of the Department's exhibits?

Please recognize the questions are limited to the purpose of clarification only. Cross examination of the Department's staff is not permitted. Please identify yourself and your organization for the record before asking any questions.

I see no one wishing to make any such inquires, so we'll proceed to allow Petitioner, Land O' Lakes to come forward and present -- make its presentation in support of the petition. Land O' Lakes now has 60 minutes to make its presentation in support of the petition.

(Thereupon the witness was sworn, by the Hearing Officer, to tell the truth and nothing but the truth.)

DR. GRUEBELE: Yes, I do.

HEARING OFFICER ESTES: I see that you've given the panel copies of your testimony as far as some analytical materials. I assume you'd like to have those introduced into the record as Exhibits?

DR. GRUEBELE: Yes, I would.

HEARING OFFICER ESTES: I'll have them introduced in the record as Exhibits number 63 and 64.

(Thereupon the above-referenced documents were marked, by the Hearing Officer, as Exhibits 63 and 64.)

DR. GRUEBELE: Thank you.

HEARING OFFICER ESTES: And please proceed with your testimony.

DR. GRUEBELE: My name is James W. Gruebele Dairy

Industry Consultant.

I won't give you the address. I'm testifying in behalf of Land O' Lakes, Incorporated which handles about 13 million pounds of milk per day and has a California membership of about 25 producers. There are 10 producers that operate dairies in southern California that are members of our cooperative.

We appreciate the Call of the hearing on a very important issue. The purpose of the hearing is to consider amendments to the milk movement incentives as provided in the pooling plan for market milk and the stabilization and marketing plans for market milk for northern California and southern California marketing areas.

The Land O' Lakes Proposal. Our proposal is to amend the Southern California Milk Stabilization plan by establishing a separate credit for Riverside and San Diego counties, and to amend the current credits to the Los Angeles, Orange, and Ventura counties.

The specific proposal is as follows:

We propose an increase in transportation credit from 50 to 66 cents per hundredweight for milk moving on a plant to plant basis from Tulare County to Los Angeles, Orange and Riverside counties. A Ventura. That's a misstatements. It's Los Angeles, Orange and Ventura counties.

Secondly, we propose an increase in transportation credit from 50 to 74 cents hundredweight moving from Tulare County to Riverside and San Diego counties. We are also proposing to establish a transportation credit for condensed skim of 72 cents per hundredweight for condensed skim milk moving from Tulare County to Los Angeles, Orange and Ventura Counties, and an 80 per hundredweight credit for condensed skim from Tulare County to Riverside/San Diego counties.

We will provide full justification for these amendments, but for now the math is as follows: The current hauling rate on a plant to plant basis from Tulare, Los Angeles, Orange and Ventura Counties is 93 cents per hundredweight, and the current differential between northern and southern California is 27 cents per hundredweight, a difference of 66 cents per hundredweight.

I'll leave the written testimony for a minute and just indicate to you the last schedule in your document in the analysis document shows a letter from Kings County Truckline showing the rates.

The current transportation credit is 50 cents per hundredweight, so there's shortfall of 16 cents per hundredweight. The hauling rate for milk on plant to plant transfers from Tulare to Riverside county is $1.01

per hundredweight and the current area differential between northern and southern California is .27 cents per hundredweight, a difference of .74 cents per hundredweight.

The current transportation of credit of 50 cents leaves a shortfall of 24 cents per hundredweight for milk hauled from Tulare to Riverside county. We are proposing an additional three cents per hundredweight transportation credit for milk moving from Fresno county into Los Angeles, Orange, and Ventura Counties and also an additional 3 cents per hundredweight transportation credit for milk moving from Fresno County into Riverside and San Diego counties.

The math on the condensed skim is as follows: The hauling rates are the same as stated above. However, the area differential for Class 1 milk is all on the fluid side. The difference in the fluid price between southern and northern California is .0031 per pound. Condensed skim is a 32 percent solids product, leaving 68 pounds of fluid carrier.

The area differential for condensed skim is 21 cents per hundredweight. This is obtained by taking 68 pounds times .0031 per pound of fluid carrier. Therefore, we are proposing a transportation credit of .93 minus .21 or 72 cents per hundredweight condensed skim shipped from

Tulare to Los Angeles, Orange and Ventura counties, and a transportation credit of 1.01 minus .21 for .80 cents per hundredweight for condensed skim shipped from Tulare to Riverside and San Diego counties. There is no need to include Fresno county, because CDI has plants in Tipton and Artesia.

The specific language would be as follows: Section 300.2, each handler located in counties designated herein as a supply county may deduct from the applicable minimum prices pursuant to Section 300, paragraph A, a transportation credit for quantities of market milk, condensed skim and market skim shipped in bulk form to a plant located in a designated county. Shipments of cream are excluded from such transportation credits. Such deduction shall not exceed amounts shown for such bulk transfers in the following schedule.

Los Angeles county basically remains the same at .24 cents. Tulare County to Riverside and San Diego Counties is .74 cents. Tulare county to Orange, Los Angeles and Ventura County is .66 cents. Fresno and Kings to Riverside and San Diego is .77 cents. Fresno and Kings to Orange, Los Angeles and Ventura is .69 cents.

The schedule for condensed skim would be Tulare 80 cents to Riverside or San Diego counties, and .72 cents from Tulare County to Orange, Los Angeles or Ventura

Counties for condensed skim.

The remainder of transportation credits specifically for northern California remain unchanged.

Transportation allowance proposal.

To make California more competitive without out-of-state sources and to provide more producer equity, we are recommending three important changes in the transportation allowance.

One is to expand the transportation allowance to Riverside county. The second is to adjust the current transportation allowance for over 89 miles in southern California to reflect the difference between the cost of the milk hauled to a manufacturing facility and to a Class 1 market. And the third is, as in earlier versions, of the State's program a transportation allowance, we recommending the supply counties be limited.

We are recommending the elimination of Fresno County and all other counties not listed below as supply counties for the transportation allowance system. As usual, we believe the transportation allowance should be available only to producers who have the option of shipping milk to a manufacturing facility.

Section 921. Producers including producer-members of cooperative associations will receive transportation allowances on shipments to plants which are located within designated areas and which, during the immediately preceding 12-month period actually processed more than 50 percent of the total milk pounds processed at the plant location into products other than Class 4A and 4B.

For purposes of this section, a "plant" includes one or more pool plants under single ownership within a designated area.

For plants located in southern California receiving area which shall consist of the counties of Los Angeles, Orange, Ventura, and Riverside from Inyo, Los Angeles, Mono, Orange, Riverside, San Bernardino and Ventura counties the following transportation allowances will apply.

From 0 to 89 miles 0. Over 89 miles .12 cents per hundredweight. From Santa Barbara, San Diego, Imperial, Kern, and Tulare counties, from 0 to 89 miles 0; over 89 through 139 miles .43; and over 139 .58 cents per hundredweight.

For plants located in San Diego receiving area, which shall consist of the county of San Diego, from Inyo, Los Angeles, Mono, Orange, Riverside, San Bernardino and Ventura counties, from 0 to 89 miles 0; over 89 miles .12.

From Santa Barbara, San Diego, Imperial, Kern, Kings an Tulare Counties from 0 to 89 miles 0; over 89 miles to 139 miles .43 cents; and over 139 miles .58 cents per hundredweight.

Justification for the Transportation Credit Changes. Southern California is a deficit market.

Milk needs to move from surplus producing ares in south Valley in Southern California either on a plant to plant basis or ranch to plant. Table 1 of 7M tables made available by the Department make the point. For March 2003 the direct shipment of milk on a daily basis from southern California ranches to southern California plants total 11,465,433 pounds per day.

But the direct shipments from northern California to southern California plants amounted to 5,244,670 pounds on a daily basis. The plant transfers from northern to southern California amount to 1,507,699 pounds per day. The bad news is that the other source milk amounted to 2,890,166 pounds per day. The amount of other source milk out of state was twice as large as the plant transfers from northern California.

There was a small amount of production that was exempt from the pool in March 2003, and there was a small amount of plant transfers from southern California to northern California. If one were to add the direct shipments from southern California, the direct shipments from northern California, the plant transfers from northern California, the shipments and transfers from other sources, the production exempt from the pool and subtract out the plant transfers from northern California, the total amount of milk accounted for would amount to 21,300,450 pounds per day.

The direct shipments from southern California to southern California plants was only 53 percent of the total. Is the milk needed in southern California? There should be very little question. The data clearly indicate the need.

Producers have a responsibility to serve the Class 1 Market.

Producer milk used for Class 1 uses is paid the highest price. But this means that the producers have the responsibility to serve that market and to support the milk movement program to ensure there are adequate amounts of milk available for Class 1 processors at Class prices plus a reasonable service charge.

The Equal Raw Product Costs.

To maintain equal product costs for California fluid milk operations, it is necessary to update the transportation credit to reflect the cost of moving milk from the Tulare plant in southern California. The cost of the haul into the Riverside plant amounts to $1.01 per hundredweight. But the area differential is only 27 cents per hundredweight, which means the transportation credit should be set at .74 cents to achieve equal raw product costs for our customer. If the customer were to pay the shortfall, then the customer would have a serious competitive disadvantage.

In effect Land O' Lakes is paying for the shortfall in all cases as will be shown later. The shortfall of our customers in Los Angeles and Orange counties is less because the cost of the plant haul is .93 cents per hundredweight. To achieve equal raw product costs, we are recommending two separate transportation credits, one for .74 cents for milk transferred to Riverside county and the second is for .66 cents for milk transferred to Los Angeles and Orange counties.

It is extremely important to adjust the transportation credit from .50 to .74 cents for milk moved plant to plant to Riverside and from .50 to .66 cents from milk moved plant to plant to Los Angeles, Orange and Ventura counties so that our customers can compete not only with other firms in southern California for Class 1 milk accounts, but more importantly with out of state fluid milk operations.

As everyone knows, a plant is being build in Arizona that is likely to be totally unregulated. This is going to be a very serious problem for plants that are required to pay the southern California Class 1 price use for fluid purposes. This is still another reason why it is important to make the necessary adjustments in the transportation credit.

Historical Precedence.

The Department of Food and Agriculture from a historical standpoint have always made cost justified adjustments in transportation credits or area differential to enable the movement of milk on a plant to plant basis. The exception to this was the decision as a result of the hearing in 2001. The attached departmental document labeled Schedule 2, that's your separate schedule I gave you, shows the summary of changes in the transportation credits and area differentials.

Starting in 1980, the area differential was .55 cents per hundredweight, which at that time reflected the cost of plant transfers. In 1981 the concept of transportation credit was introduced. Instead of a increasing the are differential from .55 cents to .61 cents, the decision was made to establish a transportation credit of .6 cents per hundredweight. The chart shows the area differential was decreased from 55 to 40 cents in August 1982, but the transportation credit was increased from 6 to 22 cents per hundredweight.

In 1983, the combination of area differential and

Transportation credit decreased by .2 cents per hundredweight. In 1984 it was increased from .2 cents per hundredweight. In 1988 there was another .2 cent increase, and another .2 cent increase in 1989 and another .1 cent increase in 1991.

There was a .5 cent increase in 1994. In 1996 the area differential was reduced to .27 cents per hundredweight, but the transportation credit increased from .27 cents to .50 cents per hundredweight. So the total compensation increased by a total of .4 cents per hundredweight.

This history clearly showed that the Department was willing to make cost justified adjustments in the area differential and/or transportation credit. This did not happen in 2001. And as a result, our customers faced a shortfall of 16 to 24 cents per hundredweight. Yet based on the evidence and based on past practice an adjustment should have been made in 2001.

Plant-to-plant milk movement is efficient. Historically Land O' Lakes has supplied our customers with standardized milk products. In the case of Los Angeles county plants, this tends to be skim milk. In the case of the Riverside plant it is two percent milk, one percent milk or whatever.

In any case, because of the California standards, it is necessary to add solids to the milk and further more the lower fat products are very prominent. The supplying of standardized milk avoids the unnecessary movement of unneeded fat in both directions. The Department of Food and Agriculture had an exhibit for the 2001 hearing which compared the efficiency of ranch to plant and plant to plant milk movement, and that is attached as Schedule 3.

The left hand side of the table shows the cost of the total package in shipping milk from Tulare Ranch to Tulare Manufacturing plant and then from the Tulare plant to the southern California fluid plant was a less costly way to serve the market than the cost of the total package in taking milk from the Kern County Ranch to the southern California fluid plant. The total package cost from Kern County Ranch milk is shown in the second column.

The last column showed the cost of the total package milk movement from the Tulare Ranch to the southern California Class 1 Plant. The latter was the most expensive way to service the southern California market. In any case, a large manufacturing plant like Land O' Lakes are highly efficient in performing functions like separating milk into cream and skim, and they are highly efficient in producing condensed skim, and standardized milk for that matter.

Our contention has always been that the plant to plant milk movement was a very efficient way to service the southern California market when complemented with a ranch to plant movement. And this study by the Department reinforces our contention.

Tailored Milk for Riverside Customer.

Our Riverside Customer buys tailored milk from the Land O' Lakes operation in Tulare. Our other customers buy standardized product like skim milk. The reason is obvious. There is a greater need for skim and solids-non-fat than there is for fat. While some may argue that this provides an advantage to these plants, our observation is that this opportunity for tailored milk is available to all plants in southern California.

Secondly, our customers pay for the standardization. Our customers do receive milk from ranch to plant. But the standardized products can only be made available on a plant to plant basis. In the case of our Los Angeles customers, a considerable amount of product on a plant to plant movement is skim milk. The tailoring of milk is an efficient way to service fluid operations in the southern California market.

Plant Transfers Only Milk Movement Program from South Valley to Riverside County.

It is important to note that the only program we have for milk movement in Riverside county is the plant to plant milk movement or transportation credit. There was no transportation allowance from South valley to southern California. And as a result of the 2001 hearing, we face a very serious shortfall and there was no alternative.

The current transportation allowance program does not apply to producer milk moved from the South Valley into Riverside county. The only milk movement program is the transportation credit. And as mentioned earlier, there is a very large shortfall from milk movement on a plant to plant basis from Tulare to Riverside county.

As mentioned before, Land O' Lakes is moving tailored milk into the Swiss plant. This avoids the unnecessary movement of fat in both directions. As pointed out in the other sections of this testimony, the shortfall makes Land O' Lakes as a supplier non-competitive with other in-state and certainly out-of-state sources of milk.

Location economics clearly supports the concept of price differences.

As stated before, the markets are different in California. The Bay Area and southern California markets are deficit while the central valley and south valley regions are areas of surplus. Bressler in an article entitled "Pricing Raw Product in Complex Milk Markets" provides a strong case that deficit markets are different from areas of surplus. The deficit markets are characterized By the existence of fluid processing plants while the areas of surplus are characterized by manufacturing operations processing butter, powder and cheese and serve as a reserve supply of milk for the deficit market when needed for fluid purposes.

His model provides support for the area differentials as once applied in California and for location differentials and varying fluid differentials for markets more distant from areas of surplus under the federal milk order system.

He states, and I quote, "These market prices and the transportation costs, then, establish geographic structures of product prices throughout the region, so that the price at any point is represented by the market price less transportation costs," emphasis added, unquote.

Other theoreticians support the work of Bressler.

Manchester states, "But costs vary from one are to another. Corn grows better in the corn belt than most other places. So it is cheaper there."

One added point on Manchester's statement regarding corn prices, not only are these prices lowest in the corn belt, but the prices also vary in the corn belt as well. Corn farmers who are located near the shipping points on the Illinois River realize higher corn prices than farmers further distant from these shipping ports.

The basis factor that supports the Class 1 prices is predicated on the principle of a comparative advantage and the economics of location. The markets are different in California. The north valley and south valley are areas of surplus. Under sound economic principle one would expect the Class 1 prices to be different in California.

Prices would tend to be the lowest in the surplus producing area and highest in the deficit markets. Manchester states, and I quote, "The geographic structure of Class 1 prices which one would anticipate in a competitive market on the basis of economic location theory has these characteristics. From the major surplus area, surplus with respect to fluid needs, prices would increase to more distant markets, reflecting transportation costs and local supply and demand," unquote.

He goes on to say, "The principle of comparative advantage and economics of location indicated that, in a competitive system, responding to economic forces, milk for fluid uses including reserve to meet day to day and seasonal fluctuations, would be produced near consumption centers, if it can be produced at or below the cost of milk from the base zone," unquote.

The low cost areas of production produce milk from manufactured uses, but at the same time these areas provide reserve supply of milk fluid and manufactured products. Each year on a seasonal basis, fluid milk is shipped out of the Lakes States Region to meet the Class 1 needs in other areas.

Manchester states that prices in all other markets would be higher by the of cost transportation from the base markets except those markets with surpluses above their own needs.

Fallert and Buxton in a 1978 study of a Class 1 Milk stated, and I quote, "First, to get milk to move from a surplus to a deficit market, the price in the deficit market must exceed the price of the surplus market by the transportation costs between markets. If the minimum Class 1 price is set under Federal orders in two such markets does not reflect these transportation costs, prices in the deficit market would be expected to rise above the Federal order minimum price."

Fallert and Buxton indicate in the absence or federal or state regulation that milk prices would be at different levels to reflect the cost of moving milk from areas of surplus to deficit markets.

A similar marketing pattern exists in California. The milk produced in the Bay Area and the southern

California market is produced primarily for fluid consumption. There is a large cheese plant in southern California which is using local milk, and much of that milk had been used for Class 1 uses prior to the construction of the cheese plants.

The Class 1 needs that were no longer met by the local milk supplies were replaced with milk from the pricing and transportation credit system that allows milk to move from the south valley to southern California Class 1 uses. Unfortunately, some of the Class 1 needs are also being supplied by out of state milk. For southern California market, the south valley is a surplus production area.

Land O' Lakes is noncompetitive in California.

An analysis was made for the milk transferred on a plant to plant basis from Tulare to southern California. The bottom line is that Land O' Lakes is experiencing a loss for the milk transferred in that manner. Competitively, Land O' Lakes cannot charge enough for the milk transferred in this way to compensate for the shortfall in the transportation credit.

In fact, Schedule 4 shows that for the 631,407,239 pounds transferred under the transportation credit program, Land O' Lakes lost a total $1,310,060. This is for the year 2002. This number was derived by subtracting the costs of processing the standardized milk and milk products from the service charges, and in addition the shortfall was added as a cost in those cases where Land O' Lakes paid the shortfall.

The costs were those reported in the Department of Food and Agriculture cost study for Land O' Lakes operation. So if the analysis is incorrect, it means that the Departmental cost numbers are wrong. The real question is why should Land O' Lakes supply any Class 1 milk under these conditions?

It makes no sense to continue to do that. In fact, if Land O' Lakes had processed these solids and fat into butter and powder during the past year, there would have been a profit of $567,993. And I say that with tongue and cheek, because first of all, in the last year, the make allowance was decreased from 16.1 to .15 cents per pound of solids and powder. And for most of 2002 the 16.1 cent make allowance was in place.

Secondly, the costs included return on investment. And I did not include that number in the alternative -- the profit number $567,993. I did not include the return on investment that the Department uses in the cost study. So the $576,993 is a minimum number and probably was larger in actual fact.

Again, we use the information from the

Departmental cost study for Land O' Lakes for butter and powder to determine this number. This part of the analysis used the current make allowances for butter and powder, as I said before. On an overall basis, Land O' Lakes would have been better off by almost -- well $1,878,053 had the milk been processed into butter and powder, rather than sold for Class 1 purposes under the current transportation credit system.

The powder, by the way, would have been sold to the Government. And there is a distinct likelihood that some of the milk to our customers would have been supplied by out-of-state sources. This situation cannot be tolerated and it makes no sense. Producers have a responsibility to see to it that the Class 1 markets are served as a reasonable return on investment, rather than a loss.

It simply means that there is a major decision. If the decision is to do nothing, then it is highly likely that at least part of the milk to these firms will be supplied from out-of-state sources. Land O' Lakes cannot compete as a supplier of milk with current transportation credit system, period.

Land O' Lakes needs to be competitive without out-of-state sources. As mentioned earlier, Schedule 1 Tables 1 through 7M, tables made available by the

Department for this hearing, this schedule shows the direct shipments from southern California to southern California plants on a daily basis from July 1985 through March of 2003.

It shows the direct shipments from northern California to southern California from the same period. It shows the plant transfers from northern California to southern California for the same period. It shows the shipments and transfers from other sources on a daily basis from January 1993 through March 2003.

It also shows the production of exempt milk and the plant transfers from southern California to northern California. The data clearly show that plant transfers have been reasonably consistent for this entire period. The volumes transferred in this way exceeded 2 million pounds per day in early 1987 and again in 1989 and in 1990, and then tended to decline some by 1998 and reached a low point in early 2001.

But since September 2001, the volumes again rose to over 2 million pounds per day. The volume for March 2003 was 1.5 million pounds per day. The bad news is that there is almost twice as much milk being shipped into California from out-of-state sources than is being supplied on a plant transfer basis in California. The other source milk has been growing, and Schedule 5 shows the hundredweights of milk being imported.

We did an analysis of the overall pool effect from the out-of-state sources of milk. The impact in May 2002 amounted to 6.7 cents per hundredweight. And the impact in January 2003 was 6.5 cents per hundredweight. The total cost to California pool for out-of-state milk totaled $19 million for the year 2002. It was almost $2 million for January 2003 alone.

The analysis shows that for the amount of milk shipped plant to plant from Tulare to Riverside and to LA and Orange counties, that the additional cost would be about $101,518 based upon our current proposal. This is how much more our current proposal would cost using the volumes we had in 2002. For January 2003, this added cost would amount to .00339 per hundredweight.

Now, assume that LOL gives up all of the milk that had been transferred on a plant to plant basis in 2002. Assume further that all of this milk is now supplied from out-of-state sources. My analysis shows that the additional cost to the pool would now increase to $974,859 per month or by 3.3 cents per hundredweight. This additional cost is 10 times higher than it would have been if the State had granted the increase in transportation credit and Land O' Lakes continued to supply the milk to southern California fluid plants on a plant to plant basis. We have people opposed to our position and some of these are producers.

Sometimes you get what you ask for. The decision on the transportation credit as a result of this hearing, in my opinion, will have far reaching effects.

It is time for Land O' Lakes to discontinue subsidization of the movement of milk into southern California for Class 1 Usage. We have performed our duty, and we are unwilling to continue to make large sacrifices because the industry is unwilling to take the responsibility to ensure that the Class 1 markets are served.

Justification for adding condensed. Land O' Lakes is Not competitive with in-state sources. Because of the freight costs of $1.01 to some customers and the .93 cents per hundredweight to others, Land O' Lakes simply cannot compete with in-state suppliers of condensed skim. The Shortfall per hundredweight is .80 cents per hundredweight for condensed skim shipped to Riverside or San Diego, and .72 cents per hundredweight for condensed skim shipped into LA, Orange and Ventura counties.

This means that the shortfall costs to Land O' Lakes is $420 a load. The statute requires that the California milk be fortified, so that all of our customers' needs to add solids to comply with the law. We cannot compete in the sale of condensed milk to our own customers, because there's no transportation credit for condensed skim. The only effective competition for the sale of condensed skim for the firms located in southern California would be out-of-state sources of condensed skim. This situation raises the important question about the lack of milk movement program for condensed skim.

Land O' Lakes is not competitive with out-of-state sources. As of September 20, 2002, I was informed by two of my clients that there were at least three loads of condensed skim moving from out-of-state sources into Class 1 plants in southern California and into northern California.

In a letter to Milk Pooling, we stated, "We believe that this situation could escalate, because of the huge economic advantages afforded to handlers that could further negatively impact the California pool."

The letter continued, "The Department policy has been to treat out-of-state milk products in a non-discriminatory manner. The accounting for condensed skim received by a Class 1 processing plant for fortification is the same whether the condensed skim comes from processing plants from in-state or out-of-state sources.

The California Class 1 plant is credited with a fortification allowance an credited the Class 2 price for in-state sources, and there is an up-charge from Class 2 to Class 1. But the Department also assumes that the Class 1 plant pays a modified for quota price for out-of-state condensed Skim milk products.

Therefore, the Class 1 plant is credited with the difference between the cost of condensed using the modified quota price and the California Class 2 price for condensed skim from out-of-state sources.

This is a major assumption. The reason is that the federal orders charge processing plants a Class 4 price for condensed skim used to fortify Class 1 products. The difference between the modified quota value and the federal order Class 4 value for 100 pounds of condensed skim has been as much as $6.54 per hundredweight. Schedule 7 shows the calculation of the value of a hundred pounds of condensed skim for August 2001 for a modified quota for the California Class 2, and for the federal order Class 4.

The difference between the value of a hundred pounds of milk used to modify a quota and the federal order Class 4 price for this particular month was $6.54 per hundredweight.

Schedule 8 shows the advantage per month for the out-of-state supplier for 3 loads of condensed skim from

August 2001 through July 2002. The total advantage over this period amounted to $2,782,623 for 3 loads of condensed skim. It is important the note that all of the in-state suppliers of condensed skim face a competitive disadvantage for serving California Class 1 plants.

While that is true, the competitive disadvantage for suppliers of condensed skim in the south valley is even larger because of the lack of a milk movement program for condensed skim.

Justification for Changes in the Transportation Allowance. The justification for adjusting the transportation allowance from San Bernardino and other counties in southern California to Los Angeles is obvious. The attached Schedule 6 shows that the hauling rate from the Barstow area into Los Angeles is .52 cents per hundredweight. And the hauling rate into the San Bernardino manufacturing facility is .40 cents per hundredweight.

The current transportation allowance is as follows: From 0 to 89 miles 0; from 89 miles to 139, .43; over 139 miles .58 cents per hundredweight. There is at least one producer -- there's more than one, there's at least two as I looked at the data, located more than 89 miles from the Class 1 plant. His hauling rate is .52 cents per hundredweight, but the transportation allowance is .58. These particular producers, and I says there's more than one, has a net profit of .06 cents per hundredweight for milk shipped into Class 1 mill plants.

For other producers, the difference between the longer distance hauled to the Class 1 Plant is .52 cents per hundredweight, and the haul to the closest manufacturing plant is .40 cents per hundredweight. But these producers receive a transportation allowance of .43 cents per hundredweight, which is way in excess of the .12 cent difference between the long distance haul to the Class 1 plant and the closer haul to the manufacturing facility.

Land O' Lakes is proposing that the transportation allowance be expanded to cover Riverside and San Diego counties. This expansion of the allowance is consistent with the transportation allowance as applied to other areas of the state. Milk needs to move to Riverside county so it makes some sense to expand the transportation allowance to those counties as well.

Proposal by Land O' Lakes for both programs would save Pool Costs.

The CDFA estimated that the overall cost savings by limiting the source counties, and by changing the transportation allowance from the high desert would provide a cost savings of $260,000 per month. I have estimated the Land O' Lakes transportation credit would add a cost of just over $100,000 per month. This would be a net savings of about $160,000, not counting the cost of the condensed portion.

Land O' Lakes is currently not supplying any condensed skim from Tulare. To the degree there is a net overall cost savings in the milk movement program, there would be additional cost savings for out-of-state milk. And I make that point very pointedly. The modified portion of the modified quota price reflects the cost of the transportation allowance and credit programs in California.

The Proposal by the Milk Producers Council. The proposal by the Milk Producers Council is totally flawed and reflects little economic theory.

The first point is all producer milk qualifies for the transportation allowance program for milk moved to a Class 1 plant. There is a transportation allowance program for southern California, but that allowance paid is 0, from 0 to 89 miles. And the reason is that their location is already reflected in the Regional Quota Adjuster. They have none. So they get paid the highest quota price in the State of California.

Again, the principle is that the transportation allowance reflects the difference between the short distance haul to a manufacturing plant and the long distance haul to a Class 1 milk plant. This principle is applied to the high desert and San Bernardino county and it is applied to milk in Imperial county. This principle would be totally ignored by the Milk Producers Council proposal.

Under the MPC program, the producers in a deficit market in southern California would not be subsidized. Before such a program is changed, we must address the Regional Quota Adjuster issue. The Regional Quota Adjuster is part of the mix and should be considered in producer equity issues.

The Milk Producers Council's proposal would continue to over subsidize milk from the High Desert southern California into southern California Class 1 milk plants. Schedule 8 shows the letter from the hauling firm that clearly indicates that the cost of the haul to the Class 1 milk plant is .52 cents and the hauling cost to the manufacturing plant would be .40 cents.

This suggests that the transportation allowance should be only 12 cents per hundredweight. It is currently .43 or .58 depending on the mileage from the Class 1 plant. To make this program more equitable one must evaluate local market conditions. The proposal by the Milk Producers Council completely ignores these economic facts.

The transportation allowance for Tulare county would be reduced significantly. The producers in the south valley already face a substantial shortfall for the ranch to Class 1 milk shipment. The hauling cost from Tulare to Los Angeles is .93 cents. The local haul is .24. And the difference in the transportation allowance is only .58. There's a shortfall of at least .11 cents per hundredweight.

The MPC proposal would reduce the subsidy for the south valley milk producer and shift that subsidy to the deficit market producer in southern California. But the quota holder in the south valley is paid the lowest quota price in the state. The Regional Quota Adjuster is .27 cents per hundredweight and has the largest regional quota adjuster in the State.

The Milk Producer's Council proposal would shift some of the subsidy for moving milk into the Class 1 Market from the south valley producers with highest Regional Quota Adjuster to the deficit market southern California producers with a 0 Regional Quota Adjuster.

The Milk Producer's Council proposal on transportation credit would simply eliminate the plant transfers from the south valley to southern California. We have already indicated that the opportunity cost for

Land O' Lakes for milk supplied on a plant to plant basis with the current transportation credit is about $2 million per year.

The fact is that Land O' Lakes is simply incurring a net loss for milk shipped to southern California in this way. Yet, we contend that it makes economic sense to supplement from ranch to plant milk with plant to plant milk because it minimizes the need to move unneeded fat in both directions. The need for solids nonfat is accentuated even more in California because of the solid standards. Economic theory indicates that the price differences between the areas of surplus and the deficit market would be equal to the cost of the freight.

This theory is almost totally ignored by the Milk Producers Council's proposal. Our proposal is very much in accord with economic theory as reflected in references by Bressler, Manchester, Fallert and Blaney, and many others.

An economics textbook has yet to be written that supports the concepts espoused by the Milk Producers Council.

The justification for the proposed reductions by MPC in the transportation from some areas in the south valley is that there are adequate amounts of milk from closer in, such as Kern County. Let's look at the facts.

Is milk movement from Tulare to Kings County to Los Angeles on a ranch to plant basis? The answer is a firm yes.

The amount of milk shipped transferred ranch to plant from northern California counties amounted to 118,170,172 pounds for February 2003. For Orange county, the total amount of milk shipped ranch to plant from northern counties amounted to 16,310,046 pounds. For Riverside county the amount of milk shipped be from ranch to plant from northern California amounted to 21,253,046.

How much milk was utilized in each of these counties? Los Angeles it was 310,136,183 pounds. For Orange it was 37,050,731 pounds. For Riverside it was 172,523,323 pounds.

What percentage came from northern California for each of these counties and in total?

A Northern California source for LA county amounted to 118,170,172. The total milk used 310,136,183. Percent from northern California, 38.1.

We add the plant to plant transfers from Tulare, that's 30,954,182. And we then re-add the ranch to plant, that means the total amount of milk from northern California to LA is 149,124,354 with a total amount of milk used of 310,136,183. The percent for northern California amounts to 48.1 percent.

Orange county, 16,310,047 from northern California source. The total milk used 37,050,731. If you go down to the bottom you see that that's 44 percent from northern California into Orange county.

Riverside county, northern California source, ranch to plant 21,253,046. Total milk used 172,523,323. Percent from northern California 12.3.

Estimates from Tulare as far as from plant to plant 21,663,087, add ranch to plant which is 21,253,046 you get 42,916,133. Total milk used 172,523,323. And a percent from northern California at 24.8. You estimate overall total for milk transferred plant to plant and plant to plant northern California total is 208,350,534 for LA, Orange and Riverside counties.

Total Milk used for those counties was 519,710,237. The overall percent of milk used by these counties and sourced from northern California was 40 percent. Riverside county is where the cheese plant is located.

I do not know that the milk supplied by LOL on a plant transfer basis is -- I do know that the milk transferred by LOL on plant transfer basis is going to Class 1 uses. That's clear. Even if the milk moved from ranch to plant into Riverside county is used for cheese. The amount of remaining milk moved from northern

California to Class 1 uses into southern California is still extremely significant.

LOL has had a long history of serving the swiss account even before the advent of the cheese plant in Corona. The MPC concept that there's enough milk close by so we don't need to pay extra charge for transportation allowances or credit is simply denied and the numbers show it.

Under the MPC program all Class 1 plants would qualify. This means if there were a bottling plant in Tulare and Land O' Lakes had one several years age. Transportation allowance would be paid for milk moving into a bottling plant in Tulare from let's say Sacramento or anywhere else. Tulare county in the 2001 produced 8.9 billion pounds of milk. The number 1 State in milk production was California with 33.2 billion, Wisconsin second with 22.2 billion; New York third with 11.8 billion; Pennsylvania 4th with 10.8 billion. And next would be Tulare county with 8.9 billion.

Tulare county, if counted as a State, would be the 5th large state in terms of milk production. There are 45 states with less milk production than Tulare county alone. Yet, the Milk Producers Council has a proposal that would actually pay for milk movement to a Class 1 plant in Tulare if there were such a plant. This is an unbelievable concept. If one were to apply this federally then one could envision the milk movement incentive to move milk from a Florida producer to a Class 1 plant in Milwaukee, Wisconsin.

Of course, not only would the freight have to be paid, but there would be the additional cost that would have to pay the difference between the blend prices, not only because the Class 1 prices are higher in Florida, but the Class 1 utilization percentage also is much, much higher.

Let's use a nonmilk example. Assume there's a program to move corn to a feed mill. Assume further that this feed mill is located in central Illinois. Does it makes sense to establish a subsidy program to allow corn to move from outside the corn belt to a feed mill in the middle of Illinois? The corn subsidy would have to be large enough not only to cover the cost of freight but also to make up the price difference between the low price in the middle of the corn belt and the corn price in the higher priced region outside the corn belt.

Again, refer back to references to Bressler and Manchester, there is no economic theory that I know of that supports the concept of moving product from a deficit market location to a surplus growing region.

Conclusion. The Department's focus of milk movement incentive programs should be to encourage milk to move to Class 1 plants in deficit areas. Both the transportation allowance and the transportation credit programs are needed to adequate supply the Class 1 needs. The combination of the credit allowance program is an efficient way to get the Class 1 milk needs satisfied without having to move unneeded fat in both directions.

The incentive under the transportation credit has been inadequate for more than two years. The current transportation credit from Tulare to our customer makes us uncompetitive with both in-state and out-of-state sources of milk, and as a result Land O' Lakes has incurred some serious losses. Again, the principles are different for the transportation credit allowance program. For transportation credits it is the cost of the plant to plant haul less any area differential.

For the transportation allowance it is the difference between the shorter distance hauled to the manufacturing facility and the longer distance hauled to the Class 1 milk market outlet. These programs should not be viewed as being competitive with one another. Both programs are needed. And the appropriate principles ought to be applied to both.

The Department on one hand seems to focus on minimizing the cost of milk movement as evidenced by the lack of any adjustment in the transportation credit as a result of the last hearing. But on the other hand, they opened up the transportation allowance to milk as far away as 400 to 500 miles, and as a result the cost of the transportation allowance program was some $260,000 per month larger than it should have been. By the way, the Land O' Lakes proposal, according to Departmental analysis, would cut the cost of the transportation allowance program by 260,000 per month. And let me just add, and that cost savings is larger than the current total cost of the transportation credit system we now have in place.

Some of the long distance milk moved to southern California Class 1 plants under the transportation allowance program because there was no home for the milk. This, of course, speaks to another issue and that's not part of this hearing. The issue is that the California make allowances for manufacturing plants need to be large enough to ensure adequate manufacturing capacity.

The milk that moved to southern California from those long distances under the transportation allowance program would likely have moved to those same Class 1 markets anyway, without any cost to the pool because the only alternative may have been to market the milk out of State, and that alternative would have been more costly.

It is extremely important to have programs built on principles under State or federally regulated systems. Except for the last hearing decision these principles have, in large part, always been adhered to by the Department of Food and Agriculture. Over the years, for example, the Department used the area differential to reflect changes in freight costs for plant transfers of milk from the surplus producing area into the deficit markets.

From the standpoint of location economics, this made sense. The location differentials were used to compensate for the ranch to plant movement of milk. The principle here was that the producer should not be disadvantaged for serving the Class 1 market. Therefore, under the current transportation allowance program, the producer should be compensated for the difference between the long distance haul to the Class 1 plant and shorter distance to a manufacturing facility.

But it is just as important to apply principle to plant transfers. A plant should not be disadvantaged for moving milk on a plant to plant basis into a deficit market Class 1 milk plant. Remember it does not work to subtract the cost of the local haul into the supplying plant in surplus producing areas. The haul cost to the local plant has already been paid. The hauling cost to the local plant has not been paid under the ranch to plant concept.

The hauling cost is avoided when the milk is moved directly from the ranch to Class 1 plant in the deficit market. It makes no sense to at all to apply the ranch to plant economic principle to the plant transfer concept. The economic theory, which I had referred to earlier, called for a price difference to reflect the cost of the freight from the surplus producing area into the deficit market. These theoreticians did not suggest subtracting the cost of the local haul to set the price differences between the deficit and the surplus market areas.

The California producers have a responsibility to ensure that the Class 1 needs of the milk processors are met. And in California this includes the provision to pay for the milk movement incentive programs. Pooled manufacturing plants also have a responsibility got make milk available for Class 1 purposes when there is a need to do so. Plants must be quote, "willing to give up" unquote, milk for Class 1 purposes when there is a need.

All pooled manufactured plants in California have that responsibility. However, just as in the case of the ranch to plant movement of milk, the plants should not be disadvantaged in moving that milk into the Class 1 plant on a plant to plant basis.

The plants using the transportation credit program should be compensated for the freight costs in moving the milk to the deficit area market. There's a significant cost difference to move that milk to Riverside and San Diego as compared to LA, Orange and Ventura. This needs to be reflected as well.

In any case, a manufacturing cooperative like Land O' Lakes should be able to charge a reasonable service charge to compensate for the services rendered like standardizing milk or making milk available when need, et cetera. Even when these reasonable service charges are made, it does not compensate a firm like Land O' Lakes for the opportunity costs for processing manufactured products when giving up milk for Class 1 purposes.

In my opinion, that should be enough of a cost to pay for the privilege of being pooled under the California system. No manufacturing operation should have to face the tremendous costs of serving the Class 1 markets as experienced by Land O' Lakes these past 2 years. It just does not maybe sense.

Land O' Lakes has always been willing to supply the Class 1 milk plants in southern California to protect the California milk pooling program. Under the current provisions, this no longer makes sense.

Again, the basic principle should be adopted in the California Milk Stabilization Pooling Program, should be that the producers serving the Class 1 market ranch to plant should not be disadvantaged from the cost standpoint. The principle should apply to plant transfers.

The cost for not adhering to these principles could be very large. We must remember the out-of-state producers have an incentive under statute to move milk into California because of the difference between the California modified quota price and the blend prices in whatever market such producers might be located. The amount of the out-of-state milk has been growing. And depending on court rulings, the advantage for out-of-state milk might grow.

It would seem to me that we should do everything we can to make California milk more competitive with out-of-state sources. Making the needed adjustment in the transportation credit allowance programs can do this.

The final principle is that the Class 1 handlers must be able to achieve equal raw product costs. This is always a challenge in a market that is deficit. The adjustment of the transportation credits in southern California will help to accomplish this goal.

I am now convinced after reading the proposal by the Milk Producers Council and some of the decisions made as a result of the 2001 hearing, that the moving to a concept of a transportation credit and away from the area differential was a mistake. The closer one emulates economic theory and with rules and regulations, that more efficient the system. And buy doing so resources are allocated more optimally, and there's less economic waste.

Paying for a transportation allowance to move milk from a deficit market to a surplus area Class 1 plant as proposed by MPC is a prime example of how resources can be wasted when economic principles fail to be applied.

This is a far cry from sound economics. We have strayed from sound economics. It is time to go back to those basic concepts. Under sound economics, one would establish Class 1 prices to reflect freight differences between areas of surplus and deficit markets without subtracting the ranch to plant haul that has already been paid as recommended by MPC. When that is done natural economics takes over and milk moves in the most efficient manner.

We appreciate the call of the hearing.

HEARING OFFICER ESTES: Does the panel have any question for Dr. Gruebele?

AGRICULTURE ECONOMIST GOSSARD: Dr. Gruebele, I've got one. On page 2 of your testimony, at the end of the first full paragraph, you mentioned that there is no need for a transportation credit for condensed skim from Fresno, California, because CDI has plants in Tipton and Artesia. But the Artesia plant doesn't have -- while, it doesn't have transportation credit for milk, it doesn't have a transportation credit for condensed skim. Would you recommend that they be given the topical transportation credit for condensed skim?

DR. GRUEBELE: I would defer to CDI to make that proposal.

AGRICULTURE ECONOMIST GOSSARD: On page 3 of your testimony, you state under the introduction to the transportation allowance proposal, you're trying to make California more competitive with out-of-state sources. How does lowering the transportation allowances in southern California and eliminating transportation allowances for the 45 northern California counties shipping milk into southern California make the system more competitive with out-of-state milk?

DR. GRUEBELE: Specifically, I can understand your question, and it probably does not. But we must establish both a reasonable transportation allowance and credit programs in order to make ourselves more competitive. And we must always maintain a competitive relationship and make the appropriate adjustments.

We do have a little bit of a problem with Tulare county milk. Tulare county milk going into southern California on a ranch to plant basis, we have a shortfall. If we're going to be more competitive, then we should probably address that issue. I did not specifically address that proposal. But I do agree with you that this statement as it stands probably does not reflect that it would improve the overall competitiveness with out-of-state milk.

But the objective in the transportation allowance, which I did not propose, from Tulare to southern California would, in deed, make us more competitive with out-of-state choices.

AGRICULTURE ECONOMIST GOSSARD: On page 5 you talk about equal raw product costs. And further on page 6 you cite you're Schedule 3, which was a document the Department presented at the last hearing in 2001, allowances and credits.

In that table, it shows that the total cost of the allowance for plant to plant milk movement was $77, from Tulare to southern California. And the ranch to plant movement the total cost of the Department -- the total cost was $77 and the total cost of the allowance was $67.

In terms of the question of equal raw product costs, why should producers pay more to have transportation credits move comparable amounts of milk than transportation allowances?

DR. GRUEBELE: First of all, let's make it entirely clear, that milk moved into Riverside county has no such transportation allowance. So your question falls far short of the issue. There is no competitive situation there at all. There is no transportation allowance for Tulare county into Riverside, period. The only milk movement program is the transportation credit program.

To make Riverside competitive with other competitors in southern California, you must take into account if they have to pay a shortfall of .24 cents per hundredweight, they're not going to be competitive with the other in-state handlers of milk. That's my point. There is just no way that these plants are going to be competitive unless we adjust the transportation credit to reflect the full freight cost difference.

If that is done, then it doesn't matter whether plant A received all their milk from local sources and plant B receives their milk all from south valley. To make those two competitive under economic conditions if there were no regulations, the plant that is receiving no local milk would drive up the local milk prices high enough so that they would be competitive with the other sources from the south valley.

This would happen under free economic conditions. This is what should happen with a program where we have a regulatory program. The freight costs from Tulare to southern California on a plant to plant basis, since most of this milk is standardized, most of it is tailored, that should be compensated for the full freight costs.

Unless we do that, I cannot understand how anybody can conclude that the plants have equal raw product cost. That's not possible, unless it's fully compensated.

AGRICULTURE ECONOMIST GOSSARD: Are you saying under an unregulated market --

DR. GRUEBELE: First -- excuse me, there's one other additional point. The plants in southern California who receive transportation allowance milk it doesn't matter, you know, what price is paid for that milk to move, it doesn't change their competitive position one iota with the plant that is receiving their milk plant to plant. It doesn't change that competitive relationship at all.

Who cares what the subsidy was, whether it's .58 cents in one case or .77 cents in the other case. From their standpoint as a processor of fluid milk, both of them are facing equal raw product costs, if the freight cost is fully compensated for in each case. No question.

It does not affect adversely the competitive position of a fluid handler who's received a transportation allowance program milk with that of a plant that's receiving plant to plant milk. It doesn't change their competitive position. They're not paying for it. The pool is.

AGRICULTURE ECONOMIST GOSSARD: Then under a completely unregulated system, you're saying that a Class 1 bottler would be willing to pay more to bring milk in plant to plant from the south valley than ranch to plant?

DR. GRUEBELE: I would reiterate what I said before. Under a perfectly competitive conditions or under free market conditions, what the plants who's receiving the milk from south valley who has no local supply would do would drive up the local supply of milk, the price of milk in the southern California market to the level where there would be an indifference between the situation where you import the milk from the south valley or whether you import it from the local area. They would be equalized.

And that's why the theoreticians like Bressler, and like Manchester has said that the cost differences would be reflected by the cost of the freight.

Neither one of them said that if you're talking about a plant to plant situation that you should subtract the local haul into the plant, they said the total freight cost ought to be compensated.

And I think it's entirely reasonable to have a standard of principle which says that the freight costs ought to be compensated. In the case of the producers, it's the difference between local haul and long distance haul. In the case of the plant, it's the freight costs minus the area differential. Those principles ought to be adhered to.

And the plants in southern California would not be competitively disadvantaged whether they bought the milk from a transportation allowance system or on a plant to plant system on a transportation credit. They would not be disadvantaged at all.

AGRICULTURE ECONOMIST GOSSARD: Getting on to another area on the -- toward the bottom of page 5, just above the historical precedence.

You mentioned that a serious problem with the Arizona plant coming on line, the southern California plants paying the southern California Class 1 price. Couldn't that just be addressed by lowering the Class 1 price in southern California?

DR. GRUEBELE: I think not only would it have to be addressed that way, and that's something I don't know what the solution of that problem is. Hopefully, we can solve that problem another way, other than lowering the Class 1 price in southern California. You're right, from the standpoint of the competitive relationship, you've got Arizona plant is totally unregulated and can buy milk at another price or pay an overbased price in California, plus some number. It's going to make it very difficult to compete without some regulatory -- some other intervention for plants in southern California to compete under any conditions.

But not compensating for the milk to milk -- the ranch to plant movement of the milk which we do do and not compensate for plant to plant movement of milk makes a problem even more severe.

And if we have a situation where a Riverside plant continues to be .24 cents shortfall, this just adds to the problem. That's my point.

I understand that that doesn't entirely solve the unregulated plant problem. I agree with you, it does not entirely solve it. Hopefully we can find another solution other than reducing the Class 1 price in California.

AGRICULTURE ECONOMIST GOSSARD: On page 7 of your testimony, when you talk about the need to add Riverside county to the transportation allowance system, do you realize that that would leave a single Class 1 plant in

San Bernardino county as the only Class 1 plant in southern California that would not be eligible for allowances, would that be equitable?

DR. GRUEBELE: Say that again, please. I'm not sure I understand it.

AGRICULTURE ECONOMIST GOSSARD: You are proposing to add Riverside county to the transportation allowance system. There are two plants in Riverside county. And the results of a single plant in San Bernardino county is a Class 1 processor. By adding Riverside county for the allowance, is that equitable for the one plant in San Bernardino county?

DR. GRUEBELE: It may not be, but I have never had the occasion to even consider that other plant, because that's never come up in the process of trying to serve them from the south valley, to my knowledge, has never been served on a plant to plant basis. That's possible. You're point is well taken.

AGRICULTURE ECONOMIST GOSSARD: This was on the ranch to plant, you were asking that --

DR. GRUEBELE: I'm sorry. I'm sorry. Okay, it's ranch to plant, okay. If that's the case, then fine. And I'd have to evaluate the data. You have that and I don't have that. If there's ranch to plant milk movement from south valley to a San Bernardino county milk plant, then maybe it should be considered, yes.

AGRICULTURE ECONOMIST GOSSARD: The same situation applies in the north Sonoma County.

DR. GRUEBELE: I'm not dealing with north. I'll let somebody else handle that.

AGRICULTURE ECONOMIST GOSSARD: If your proposal is adopted, just as it stated, it would, as you said, create cost disadvantages from a plant in San Bernardino county, under your definition of what this deficit, might there be other counties?

DR. GRUEBELE: There might be. I'm not looking at northern California. Let somebody else do that.

AGRICULTURE ECONOMIST GOSSARD: On page 11 of your testimony, you mentioned that other source condensed skim can have a competitive advantage because of the assumption pooling makes about the raw product costs versus the actual raw product costs. That was toward the bottom.

DR. GRUEBELE: Yeah, the credit of a modified quota price, which you make in condensed skim, versus what the Federal order charges, those plants use as Class 4, yes.

AGRICULTURE ECONOMIST GOSSARD: Do you think there is a need for a change in pool accounting to more correctly reflect the cost of that condensed skim? Would that be part of the solution?

DR. GRUEBELE: It think that is a distinct -- yes I think it's a reasonable -- as a matter of fact, we made a recommendation, it wouldn't have solved the entire problem, but it certainly is a pooling issue, yes.

I think the only problem is that there is a court case, and I understand that, and to make those changes now may not be prudent.

AGRICULTURE ECONOMIST GOSSARD: On page 13, when you're dealing with the Milk Producers Council's proposal, you mentioned that one of the reasons you feel that southern California shouldn't have a transportation allowance for local milk is that they don't have a regional, they have 0 Regional quota Adjuster.

But the Regional Quota Adjuster only applies to quota milk. Quota milk only accounts for 47 percent of the milk in southern California. That means there's 53 percent of the milk that might like to go to a Class 1 plant, that doesn't get a 0 or a QA, and it doesn't get a transportation allowance either.

DR. GRUEBELE'a producer decision, whether they hold for it or not is their own decision. They can go buy it if they want to, if they want to take advantage of it.

I'm still standing by this, that the regional quota adjuster is 0, therefore that issue needs to be taken into consideration. The other issue is they've got to have an alternative manufacturing facility to which they supply their milk. You just can't go apply a .43 cent per hundredweight principle. That's what we did last time. We overpaid -- and .58 cents in some cases. We overpaid the high desert producers for milk shipped into a Class 1 milk plant, because we didn't abide by the principle that you must look at the alternative milk that's shipped to a manufacturing facility.

So in that particular case, the lack of adjuster from 0 to .89 cents may fail in both ways. I'm not sure. You must also comply with the local shipment to a manufacturing facility on the longer shipment to a Class 1 milk plant. It may not make sense to have a transportation allowance on that basis alone. They may not have the alternative of shipping milk to a manufacturing facility.

Or the manufacturing facility may be located in further way, for example, maybe is located in Corona, California, and they're a further distanced from that market than they are to a Class 1 plant. You don't need to pay a transportation allowance in those cases.

AGRICULTURE ECONOMIST GOSSARD: Finally, this is just strictly a clarification. On page 12 of your testimony, toward the top just below justification for changes. The third line of the first paragraph you mentioned attached Schedule 6, isn't that attached Schedule 9?

DR. GRUEBELE: Pardon? Oh. Could I have made a mistake?

AGRICULTURE ECONOMIST GOSSARD: Never.

DR. GRUEBELE: Oh.

AGRICULTURE ECONOMIST GOSSARD: It could have been my mistake, so I thought I'd check.

DR. GRUEBELE: You misread it, I think.

AGRICULTURE ECONOMIST GOSSARD: That's possible.

DR. GRUEBELE: Yes, you are correct, Mr. Gossard.

AGRICULTURE ECONOMIST GOSSARD: In that one occasion. So instead of Schedule 6, that should be Schedule 9?

DR. GRUEBELE is correct.

AGRICULTURE ECONOMIST GOSSARD: Thank you very much.

SENIOR AGRICULTURAL ECONOMIST ERBA: Dr. Gruebele, condensed milk does not receive any kind of a credit for allowance now?

DR. GRUEBELE: That's correct.

SENIOR AGRICULTURAL ECONOMIST ERBA: Why not?

DR. GRUEBELE: Well, I'll tell you why we didn't ask for it, because we didn't understand it.

We thought we could charge a southern California plant the southern California Class 2 price. That made a lot of sense, and it made sense from the buyer's standpoint too. Gosh, the prices are the same whether I buy it from a southern California plant or from Tulare. The price is the same.

Well, what we didn't know, what we didn't understand is that the credits are such that in that particular case if he buys condensed from the south valley, he actually overpays, and he's not compensated for it anyway. So it's a noncompetitive issue. So that's why we didn't ask for it before.

So part of the reason it never was brought up before, we thought it wasn't a problem. We thought we had an 82 cent area differential for condensed skim. We didn't have that. And at one time, the cost of the transportation was less than .82 cents. It wasn't an issue. That's because we didn't understand it.

I think that's part of the reason. Ranch to plant, of course, there aren't too many producers that have an evaporate to make condensed skim, so obviously we don't -- you know, we wouldn't move ranch to plant.

SENIOR AGRICULTURAL ECONOMIST ERBA: You've suggested that we limit the counties that can shift into southern California and receive a transportation allowance. I'm trying to understand why you want to do that. If the milk is moving from those counties and it goes to a qualifying plant, why should they not take that allowance?

DR. GRUEBELE: There is -- you know I looked at the schedule, and I see if I can. I may not be able to locate it. Maybe I can.

Just a second.

If I can't, I can't.

There's a large volume of milk that's currently shipped ranch to plant from Kern to Tulare. There's some Tulare milk shipped north. There's all kinds of milk. Why in the world do we pay for milk coming from Placer County, where I live, and pay them a transportation allowance to ship it all the way down to LA? There's something wrong with that picture. There is so much milk available locally that we've always been arguing, I've heard that time and again in these hearings, use the local milk first. Don't -- you know, there's plenty of milk available, blah, blah, blah.

And then we come along with a principle saying well it comes from Placer County 500 miles away, so be it, pay them. There's so much milk that it goes right through Tulare county, with 8.9 billion pounds of milk in the county, the 5th largest State in the nation. And you're saying we should pay for milk coming from Placer County to LA, when there is 45 other states that have less milk than Tulare county. My goodness, there must be enough milk to supply whatever is needed in southern California without having to go 500 miles north to get it.

DAIRY MARKETING BRANCH CHIEF IKARI: Dr. Gruebele using that logic, isn't there enough milk in southern California to serve the Class 1 needs?

DR. GRUEBELE's: That's obviously not the case. That milk is not available.

DAIRY MARKETING BRANCH CHIEF IKARI: Two questions. Is there enough milk production in southern California to satisfy the Class 1 needs?

DR. GRUEBELE: I don't know. To be honest with you, I haven't done those numbers. But I do know that 53 percent of the milk is supplied from southern California to southern California, and the rest of it is imported. I do know that. And that's been going on for 50 years.

DAIRY MARKETING BRANCH CHIEF IKARI: Could you also use that same argument then that perhaps Tulare county --

DR. GRUEBELE: No, I don't think so.

DAIRY MARKETING BRANCH CHIEF IKARI: -- that it is tied up in Tulare County manufacturing facilities?

DR. GRUEBELE: No. It's not tied up. The milk can be available. We've been supplying milk for 50 years from Tulare. And we've done it now with a $2 million opportunity cost the last 2 years. So we've been willing to supply that milk. We've demonstrated that fact, and it's been going on for a long, long time. We changed that supply county concept, not too long ago to make it open it up.

Why? Why was that kind of principle okay in the past when Tulare county was not nearly 8.9 billion? Now, all of a sudden, we change the policy to open it up to all counties.

Milk continues to grow. We continue to get larger and larger and larger, then we change the concept. All of a sudden we don't have enough milk. We've got to go to northern California to get it. There's something wrong with that picture, extreme northern California.

AGRICULTURE ECONOMIST GOSSARD: Dr. Gruebele, but hasn't Fresno county always had the same transportation allowance in southern California as Tulare, and you eliminated them? I mean, that would be an entirely new policy.

DR. GRUEBELE: Sure. I mean, Fresno county is the next county up. And again, I think with the growth we've had in milk supply -- Kern County, this is another county that's growing tremendously, tremendous increase in milk production. Milk moving from Kern county and Tulare every day of the week. That milk could be made available to southern California. There's enough milk there.

So I guess that's one of the reasons. I would say that's what's changed. Some things change. What has happened is that south valley's milk volumes continue to grow. The surplus becomes more and more and more surplus. And I think we need to recognize that change. We probably don't need Fresno county anymore. We had it. We probably don't need it now.

AGRICULTURE ECONOMIST GOSSARD: Well, if you're saying Kern County milk is going into Tulare county, if we take your proposal one step further, if we eliminated Tulare county, would that mean that we have enough milk in Kern County?

DR. GRUEBELE: I don't think so. I really don't think so. I've looked at the those numbers, and I do not think that would be doable. I think one has to be reasonable. There is a plant -- as far as I know, there's a plant in Kern county now. You've got to recognize that. You just can't say well sorry, we'll close that plant because it doesn't belong there, and all milk now has to transfer.

I think we need a milk movement program that's reasonable. I think what we have now with Tulare, Kings and Kern County, I think that's a reasonable approach. Yeah, we can service that southern California market. And should the milk move from Kern county first, sure, that's reasonable. I don't think that's unreasonable at all.

Yet, we have a program -- I don't know why. I don't know why Kern county milk is moving to Tulare. I have no idea why. And why there is some ranch to plant milk from Tulare going right past those producers. They're moving their milk north to Tulare.

You're not going to build the perfect system, sir.

AGRICULTURE ECONOMIST GOSSARD: Would you say that possibly then in that situation that the transportation allowance, the .43 cents and the .58 cents bracket mileage allowances are perhaps too far apart, that they need to be closer together, without saying whether the close-in milk should be raised or the far-end milk should be lowered?

DR. GRUEBELE: No, I don't think that -- if ranch to plant milk has a need to be moved to southern California, for whatever reason, then I think you ought to have a reasonable compensation for that. The answer is no, I would not advise that we reduce or decrease the difference between the 2.

Interestingly enough, we have a producer in the

Kern County region right now, in talking to my client, he was asking well, what kind of transportation allowance would be paid to this producer? I said .43 cents. My gosh, he says, "The local haul versus long distance haul, we make money on that deal." That's what we have now.

So we're making money on that particular producer using the .43 cent haul. That's more than necessary to compensate for the local haul versus the long distance haul in that particular case.

AGRICULTURE ECONOMIST GOSSARD: Is it possible then the .58 cents from Tulare county is making too much more?

DR. GRUEBELE: Is what?

AGRICULTURE ECONOMIST GOSSARD: If you're making money for the Kern county milk at .43 cents, is it possible there's even more profit at the .58 cents?

DR. GRUEBELE: Absolutely not. The freight costs eat it up and then some. We have a shortfall from Tulare county. That's not the issue. There's a shortfall in Tulare county. There's no question about it. If you take the freight rate to southern California and the difference between a local haul and a long distance haul, you do not fully compensate for that difference with a transportation allowance of .58 cents. There's just not. It's short for what we need. But that's not true depending on where you're located in Kern County.

SENIOR AGRICULTURAL ECONOMIST ERBA: Dr. Gruebele, you stated that producers have a responsibility to serve the Class 1 market. To your knowledge, is that anywhere explicitly in Regulation or in California Code or that must happen, or is it just something to comply?

DR. GRUEBELE: I don't know that it's -- I'm not sure I can answer that question if it's specifically a Regulation or a Code or what.

But it's a principle that we know why the Class 1 milk prices have been established at those higher values. Because it costs more to service that market, you've got to have Grade A milk, and it's got to be market grade quality. That's the original concept. That's why there was a Class 1 price that was higher than for Class 2, 3 and 4 for manufacturing uses.

So the incentive isn't there. The producers have been paid that price. Therefore, they have responsibility to certify. And if there were no regulatory program, you wouldn't need any incentive. The incentive of the price itself would be more than adequate to have that market service. People would be fighting over those markets as we all know, if there were no regulatory program.

So I think it's just whether or not specifically in the code, it should be, if it isn't.

SENIOR AGRICULTURAL ECONOMIST ERBA: I have heard people make the distinction between producers serving the market by the first haul, meaning ranch to plant, versus a plant to plant haul. Do you make such a distinction?

DR. GRUEBELE: In my opinion again, I think that both programs serve a purpose. I think that there's good reason to use ranch to plant when that makes sense. There's good reason to use plant to plant when that makes sense. And I'm saying any time you have a California standards program, you need additional solids, you're not going to -- you know there's no producer who can supply that. It can't be done.

There's no one percent milk, that I know of, from any cow that I know of, no 2 percent milk and certainly no 210 milk. So I think there are reasons to have both programs, and I think that -- so this is why I think that whether or not it's ranch to plant or plant to plant, I think we ought to make that as efficient as possible, and that's my proposal.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: Dr. Gruebele, would you think that the call provisions are a regulatory scheme that acknowledges the producers have a responsibility to serve the Class 1 market?

DR. GRUEBELE: I think the Call provision, let's say, makes people do what they should other wise do anyway. I think that the call provision, of course -- I think plants have a responsibility as an example. Pool plants have responsibility to serve a Class 1 market. And I think a lot of times the call provision, as I recall, the call provisions were made to plants or pool plants, say please remove your milk.

I think they have a responsibility to be pooled in California and to receive money from the pool and to be a pool plant, they have a responsibility to serve the market.

The Call provision simply is a mechanism by which you can force somebody to move milk whether it is needed in the Class 1 milk market.

There have been numerous other approaches that people have used. Pooling requirements or whatever, you must shift a certain percentage of your milk in the Class 1 market every month. The disadvantage of some of those requirements and federal orders has been that you move milk and it's not needed by the Class 1 milk plants, so they load it right back -- sometimes they made them unload the milk and then load it right back on and take it back to the manufacturing plant.

Now, that's an economic waste. So the Call provision in that sense has some advantages. You're not going to call the milk unless it's absolutely needed.

But the call provisions are there because sometimes milk has not been supplied, when it was needed as a class 1 purposes. I'm not sure that answers your question. But I think the responsibility -- the responsibility is -- the plants have a responsibility. The producers have a responsibility. The plants have a responsibility because they are pooled. The producers have a responsibility because they are paid the highest valued use for Class 1, therefore that market should be served. And the producers should take the responsibility for a milk movement incentive program for whatever the cost may to be get the movement -- the milk to market.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: Back to the questions or the issue of milk moving from Placer county from extreme northern California to southern California receiving a transportation allowance.

You indicated in your testimony that that milk probably would have moved to southern California plants anyway.

DR. GRUEBELE: I'm suggesting, as a possibility. I'm not saying necessarily. It might have been enough to tip the whole thing by the fact they were paid the transportation allowance. They're going to look at their alternatives, and say, you know, which is my best alternative which I will suffer the least loss in that particular case, because it doesn't -- obviously it may not have had a home with the milk.

And so if there's no manufacturing facility that was willing to take that milk, then maybe the alternative is to ship it Idaho or some other place out of state. And it may not have had a home otherwise.

And as a result, you have a situation where they're going to say well, you know, if I can find some Class 1 handler to take my milk, I have a transportation allowance, at least I paid for part of it. And I'm saying that milk could have moved through southern -- I'm saying could have, moved to that same Class 1 plant. Without a transportation allowance program, we wouldn't have had to pay that out of the pool to get that milk to move. It obviously needed someplace to go.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: With your clients press release in the last couple days of their sale of the Justine plant to a new business entity, do you think some of those milk movements that are now receiving a transportation allowance will no longer move into southern California?

DR. GRUEBELE: You're talking about the producers that used to service that particular plant? Is that what you're talking about?

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: I'm talking about the milk now that you are suggesting may well have been shipped to a southern California Class 1 plant, regardless of the transportation allowance.

DR. GRUEBELE: Oh.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: Do you think with the recent sale of that plant, that that milk will now have another home and may stay in northern California?

DR. GRUEBELE: It's possible. It's possible. I don't know. Again, I think that there's reasons that I cited before why I thought that we could limit the supply count. I still say that.

Based upon the economic analysis that the Department made, that our proposal would save $260,000, I think is worth doing. I just don't think it's necessary. There's enough milk in Tulare county and other places that you don't need to expend that money to move the milk from southern California.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: And on the RQA issue, when the RQAs were established, all of the Class 1 monies that were generated by the pool went to quota producers, did they not?

DR. GRUEBELE: Excuse me, I didn't hear your last part.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: When they were established, all the monies generated by the pool or by Class 1 sales, all of those monies went to quota producers only, did they not?

DR. GRUEBELE's: That's true. That is true.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: So --

DR. GRUEBELE: You're talking about prior to the RQAs?

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: I'm talking about when they Regional Quota Adjusters were established and up until 1994 --

DR. GRUEBELE: Right.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: -- all of the Class 1 revenue was distributed to quota producers only.

DR. GRUEBELE: And to 2 and 3.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: Correct. And occasionally 4.

DR. GRUEBELE: And occasionally some 4.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: And the Regional Quota Adjuster is only applied to quota milk.

DR. GRUEBELE: True.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: So therefore, using that logic then, that quota milk that was receiving the Class 1 dollars, that was closer to Class 1 market was receiving a higher value for being closer to that Class 1 market, correct?

DR. GRUEBELE: Correct. And the producers who shipped their milk to the southern California market got that quota price also. They got the quota price that it was existing in the recipient market.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: Didn't all quota producers across the state regardless of where they shipped their milk receive that same quota price?

DR. GRUEBELE: Are you talking about prior to the RQA or before? It was before the RQA, the way the milk moved was the location differential. And the southern California producer -- I mean the south valley producer who shipped his milk from the Class 1 plant in southern California was then able to get the southern California quota price, rather than the quota price where he was located. That's what made the milk move at that time.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: And in today's system, with the fixed differential at $1.70 between quota and overbase, aren't all producers receiving Class 1 dollars?

DR. GRUEBELE: Absolutely. Yes, they are. And they -- of course, what happens to those dollars is that you have to fund the $1.70 differential also. You have to take that into consideration. But you're right, it is now a pool -- it is a marketwide pool, in a sense, for the overbase producers, yes.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: So under the old system, the concept was that as quota producers, quota producers were the only ones receiving the Class 1 money, and the quota producers that were in southern California should be entitled to a little higher price for that quota milk.

Has the economics of that changed now such that the overbase producers across the state are receiving Class 1 dollars uniformly regardless of where they're located?

DR. GRUEBELE: It's not uniform, of course. The overbase shipper still gets $1.70 less for his milk when the day is done. But are there any Class 1 dollars in that overbase priced? There probably is in most markets.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: And you point out one thing, I just want to touch on, and that is those Regional Quota Adjuster dollars are used to help finance the $1.70 spread?

DR. GRUEBELE: Yes. Well, yes. And first of all, the overall RQAs do help to fund that. But the overall blend in the overbase has to pay for the $1.70 differential, then you add back money from the RQA to help

fund it, yes.
MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: The reason I bring this up is there was some suggestion that the Regional Quota Adjuster system could be eliminated without impacting any producers except for producers in southern California. But wouldn't, if we were to eliminate the Regional Quota Adjuster system, wouldn't all those prices be reduced by the amount the RQAs collected?
DR. GRUEBELE: If you eliminated the RQA, that would mean you wouldn't have the cost savings to fund the $1.70, is that your point?
MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: Yes.
DR. GRUEBELE: And sure it would affect -- and let me just make the point, my testimony did not say eliminate the RQA. I said it's an important factor to consider in the mix. The fact that the Tulare county producers is .27 cents less for quota milk than southern California needs to be considered.
If you eliminate the RQA, then in order to fund the $1.70, means the overbase price would be lower, and the quota price would also be lower. That is true. But the total dollars should still be the same, however the monies would now be redistributed among producers in California.
The total dollars are in place. It would just be

means of who gets it, that's the only difference.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: Okay.

MILK POOLING BRANCH CHIEF LEE: One question for you, Dr. Gruebele. You mentioned here that if some of your proposals are adopted as you have proposed, that it would be -- it would help with the issue of milk coming in from out-of-state sources, that it would be more competitive.

How much reduction or how much advantage would you have over out-of-state sources if we did adopt your proposal? Have you looked at it?

DR. GRUEBELE: The point is -- the point that I want to make is since we have an opportunity cost of almost $2 million, we have to look at our whole cards and say does that make any sense to do this anymore? When do we stop doing that?

My point was that if we stop doing what we've done in southern California, oh could it be supplied by other sources? Of course, in California, hopefully it would. But there's some likelihood that the out-of-state situation would grow even more. That was my point.

I'm not saying that, you know, the competitive advantage that the out-of-state milk has is the difference between wherever those producers are located, their blend pricers, the modified quota -- let's face it, there's no question that it provides an economic advantage, depending on what the freight costs are.

And I'm not sure that it reduces their opportunity to service southern California. All I'll saying is, I think we ought to do everything we can to make our California milk competitive. I'm not saying we can do it.

I'm not saying we can totally do it. I'm not saying we can make the out-of-state milk go away because we've done this. We serviced -- we have serviced these markets, even at a loss. And if we don't do it, that means the milk has to come from somewhere else.

Could that mean there's further opportunities for out-of-state milk to come in? I think it's obvious. I think, yes, there certainly could be.

I don't know that that answers your question. But I would say I am not sure it would subtract from their advantage to service the California market. But if you make our customers noncompetitive or make them pay for the shortfall they're going to look at their whole cards and say where can I go? How am I going to reduce my cost of my milk. And the answer might be out of state. I think that's an issue that we always face.

MILK POOLING BRANCH CHIEF LEE: I thought maybe you had some dollars and cents.

DR. GRUEBELE: I don't have any specific numbers, except to say that I think it is important, and I haven't -- I mean I'm glad to do a further analysis on this and to answer your question further. I have not done this. I guess I had enough work to do to develop what I have here, so I just didn't have the time to do that.

But it is an interesting question. But would it impede the out-of-state milk from coming in at all? Of course not. I think that you still have to face the situation that they have modified quota versus a California -- versus their own blend price, as their competitive advantage to service the California market.

MILK POOLING BRANCH CHIEF LEE: Thank, Dr. Gruebele.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: Well, one last question. On page 12 of your testimony, you indicate that you'd like to expand the transportation allowance system to cover Riverside and San Diego counties. Don't San Diego county plants already receive a transportation allowance, plants located in San Diego can receive an allowance for Milk moving in?

DR. GRUEBELE's: That's possible. I added that. You know there -- I don't know how many plants we have in San Diego at all. I know Escondido has closed. It becomes almost a moot issue. I just don't think there is much of any deed even for a transportation allowance to go into San Diego, but you may be right, sir.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: My reason for asking was to clarify, were you meaning San Diego as a county of destination or a --

DR. GRUEBELE: Yes.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: Not an economic supplier county.

DR. GRUEBELE: Right.

HEARING OFFICER ESTES: So do we have anymore questions for Dr. Gruebele?

Did you want to present a post-hearing brief at all?

DR. GRUEBELE: Do I want to do what?

HEARING OFFICER ESTES: Did you want to be able to present a post-hearing brief?

DR. GRUEBELE: Oh, I probably will after I hear the rest of the testimony.

HEARING OFFICER ESTES: Okay. I'll take that as a request.

Thank you for your testimony today.

DR. GRUEBELE: Further more, I need the work.

(Laughter.)

HEARING OFFICER ESTES: As do we all in these difficult times.

Again, thank you very much.

We will now proceed to a presentation of the alternative petition of the Milk Producers Council. The Milk Producers Council has 30 minutes to make its presentation.

Mr. Vanden Heuvel, would you please state your name and spell your last name for the record.

MR. VANDEN HEUVEL: Geoffrey Vanden Heuvel. That's G-e-o-f-f-r-e-y. And the last name is V as in Victor a-n-d as in David e-n-h-e-u-v as in Victor e-l.

(Thereupon the witness was sworn, by the Hearing Officer to tell the truth and nothing but the truth.)

MR. VANDEN HEUVEL: I do.

HEARING OFFICER ESTES: I see that you've given out a written statement today.

I assume you'd like to have that introduced in the record as an exhibit?

MR. VANDEN HEUVEL: Yes, I would.

HEARING OFFICER ESTES: We'll introduce it into the record as exhibit number 65.

(Thereupon the above-reference document was marked by the hearing officer as Exhibit 65.)

MR. VANDEN HEUVEL: Thank you.

HEARING OFFICER ESTES: So please proceed with your testimony.

MR. VANDEN HEUVEL: Thank you Mr. Hearing Officer and members of the panel. My name is Geoffrey Vanden Heuvel. I am a dairy producer located in San Bernardino county. I am testifying today on behalf of the Milk Producers Council, a dairy producer trade association with about 175 members located primarily in southern and central California.

The testimony I am about to give is based on Milk Producers Council's policy principles and supports positions taken by the Board of directors at a meeting in April of 2003.

MPC thanks the Department for calling this hearing, and also for the fine prehearing analysis work done by the Department staff.

On page 6 of the June 28 and July 2, 2001 hearing panel report, we find the following paragraph. I quote, "The panel adopted the idea that producers who serve the Class 1 Market ought to be rewarded as one of the basic criteria for evaluating the proposed amendments. Among the other criteria used were the idea that the closest milk to the market ought to move first and that any regulated system ought to minimize costs to the pool," end quote.

Milk Producers Council agrees with the panel and has used these principles as well as the concept of equity as the basis for the Milk Producers Council alternative proposal.

The following points summarize our proposal:

Only Class 1 milk in California should qualify for transportation incentives.

2, All Class 1 milk in California should qualify for transportation incentives. The current plant eligibility standard defined in Section 921 is too loose because a lot of non-Class 1 milk is eligible for subsidy. On the other hand, the receiving area designations are discriminatory.

3, all California Grade A milk production is eligible.

4, the minimum allowance starts at 0 miles for all eligible plants and increases in constructive mileage brackets until the concentric zone emanating from the plant encompasses adequate supply of milk to cover all the Class 1 needs of the plants in that area with an adequate reserve supply, at which time the rate is capped and stops increasing.

5, Transportation credits continue but the combination of the area differential and the transportation credit shall not exceed the applicable transportation allowance for the distance the milk travels.

We have proposed specific pooling plan and stabilization plan language which we trust will implement the proposal we have made, but we would certainly defer to the Department to modify that language based on this hearing and your expertise in crafting plant language which accomplishes the goals that we've put forward.

Transportation Incentives should only apply to Class 1.

The current definition of an eligible plant for the purposes of receiving a transportation allowance is very loose. Department analysis indicates that there is a significant amount of Class 2 and 3 milk that is eligible under current rules to receive transportation allowances.

We have not yet been able to determine exactly how much based on the data presented, but it seems to be in excess of a billion pounds per year just in southern California. Given that the southern California class 2 and 3 price differential over the 4A price is .91 cents and .64 cents respectively, and given that there appears to be a tremendous amount of milk qualifying for the highest transportation allowance level in southern California, which is .58 cents per hundredweight, it is clear that a significant portion of the differential value to the producer of the Class 2 and Class 3 usage of milk is being drained out of the pool to pay the cost of the transportation allowances on this Class 2 and 3 milk.

Further more, there are a number of plants that if they are in an eligible receiving area meet the current 50 percent requirement on Class 1, 2 and 3 but have a fair amount of Class 4A or 4B usage, which is then also eligible to receive transportation allowances.

The whole purpose of the transportation incentive program is see to it that Class 1 is served. The eligibility requirements for receiving transportation allowances should be established to only cover Class 1 as we have proposed.

All Class 1 plants should be eligible for transportation allowances.

The principle that producers who serve the Class 1 market should be rewarded is inequitably applied in the current regulation. All producers shipping to eligible plants in Sacramento, the Bay Area, and Solano are eligible for transportation allowances. But producers shipping to Class 1 plants in Modesto and Fresno are not eligible, even though those plants pay the identical Class 1 price into the pool that the plants in the Bay Area, Sacramento and Solano areas pay.

In southern California only producers located over 89 miles away from the plant receive a transportation allowance. The southern California Class 1 price is only .27 cents higher than the northern California Class 1 price and yet there is no incentive for the "close in milk" to serve the Class 1 market in southern California, and the .43 cents and .58 cent incentives that do exist greatly exceed the .27 cent higher southern California Class 1 price differential.

We fail to see the rationale for excluding certain producers and Class 1 plants from being eligible for transportation allowances. That is why we are proposing that all California producer milk delivered for Class 1 use be eligible for transportation allowances based on a uniform mileage schedule.

Our mileage schedule is equitable and rationale. The mileage schedule we have proposed was designed in such a way as to leave the northern California situation roughly in the same position they are in today, while establishing a system that will work well in the southern California area.

Department analysis shows that our plan does not significantly alter the northern California situation.

For southern California the cap is particularly relevant. Our goal is to make sure that there is enough milk production covered by the transportation allowance to allow the Class 1 market to be served with a reasonable reserve supply. According to the Department's exhibit, titled "Cost Comparison of Transportation Allowances," table 5, for the year 2002, $2,616,364,050 pounds of milk were needed for Class 1 in southern California.

According to the 2002 annual California dairy statistics and I think that was Hearing Exhibit 36A, milk produced in the traditional southern California counties totaled at 5,643,866,426 pounds. When you add that total the 1,757,561,961 pounds produced in Kern county, you come up with a total available milk supply in California of 7,401,428,387 pounds or 283 percent of what is needed for Class 1. Certainly, that is a sufficient reserve supply.

The cap of .45 cents is based on what it would take to move milk from the outer edge of the zone of milk production needed to supply the Class 1 market. The hauling rate from Kern County to Los Angeles is just short of .70 cents per hundredweight. A transportation allowance of .45 cents should be able to attract the milk from much of that outlying county to Los Angeles.

The Class 1 plants located in other parts of southern California are located even closer to the major milk sheds of southern California than the Los Angeles plants. With the implementation of a local southern

California transportation incentive as we have proposed, they should have no problem attracting an adequate milk supply to meet their Class 1 needs.

Transportation credits.

Although, the responsibility of producers is to supply raw milk to the Class 1 market, the MPC proposal does allow for a subsidy for plant to plant transfers of milk and even expands the opportunities for those credits by eliminating the designation of supply counties and deficit counties.

However, by limiting the transportation credit to what the comparable cost to the pool of the transportation allowance for milk shipped to similar distances, the system has the safeguards necessary to prevent abuse.

Land O' Lakes proposal should be rejected.

The Land O' Lakes proposal is designed to take us back to the bad old days of the system picking winners and losers in the transportation subsidy game. The Land O' Lakes proposal does nothing to advance the principles outlined by the hearing panel quoted above. It does not reward producers who serve the Class 1 market.

On the contrary it charges producers to reward the plants who ship milk to the Class 1 market by completely removing the shortfall that exists in the current program and thereby creating a windfall for plants to move milk plant to plant rather than ranch to plant.

The proposal does nothing to encourage the closest milk to move first to the Class 1 market. On the contrary, it encourages distant milk to supply the Class 1 market to the detriment of the close in milk.

The Land O' Lakes proposal does seek to minimize the costs of the transportation subsidy program by eliminating the ability of their competition to access the transportation incentive program. The Land O' Lakes proposal is bold, but blatantly one sided. It violates all of the principles that should guide our transportation incentive program and should be rejected in total.

There are a few additional comments. We'd like to thank you for the opportunity to testify today, and request the opportunity to submit a post-hearing brief. And then also a comment on a few of the things that we heard in the previous speaker, Dr. Gruebele.

Dr. Gruebele makes a very interesting point on behalf of Land O' Lakes. He makes the point that Land O' Lakes is losing money on plant to plant transfers and that they need more subsidy in order to be a competitive, and then makes the bold claim that this is the most efficient way to move milk.

There's something wrong. It depends, I guess, on your definition of efficient. If efficient is cost effective, then why the huge subsidies and why the loss of money.

The other interesting point to make and, certainly it may be made by others today that Dr. Gruebele made about the one producer, a couple of producers in the high desert, who actually make money. I think it's important to note that Dr. Gruebele also remarked that there are Kern county producers who are making money because of the .43 cents. And I think that's an important thing to note.

Dr. Gruebele made another point that under a true free market the local milk would be -- the price, the local milk price, would be increased. And this has been a huge concern of the southern California producers. We have a lot of competitive disadvantages in southern California. We operate in a very high cost area, and the Department's cost surveys will prove that out. And those are all part of the hearing record. The difference in production costs between southern California and the south valley for example.

The one competitive advantage we have is that we are physically located close to the southern California fluid market.

And as Dr. Gruebele, I think, accurately predicts if we were in a true free market, the local price would go up because we would be the closest supply.

But because of the transportation subsidy system, the milk located much farther away from us is at least as competitive, if not more competitive. I mean with admissions in this hearing record of the Kern County situation, where producers actually can make money in some cases, give more in a transportation incentive than even their local haul is. And we don't have the opportunity in southern California to take advantage of our one competitive advantage.

And that's why if we're going to maintain this transportation subsidy system, we have to reimplement -- we have to reflect the fact that the local milk ought to have some incentive to go to the Class 1.

And then finally I wanted to address the issue of the Regional Quota Adjusters. Mr. Horton has submitted a letter and I'm not sure exactly how the Department is going to view that letter that I saw on the table.

Certainly, it was not a timely proposal, if it's going to be considered as a proposal, which is to eliminate the RQAs. And so, you know, in preparing for the hearing today, it's a little unfair, I think, to insist that we have fully fleshed out the defense of the current RQA system. But I think Mr. Shippelhoute, I believe is questioning points out one of the huge issues about trying to do something with the RQAs.

If the RQA only affected quota holders, that would be a different discussion than the reality that we're facing today. The reality we're facing today is if you simply eliminated the RQAs made everyone -- all the quota $1.70, there would be somewhere in the range of $800,000 to a million dollars a month, whatever that number is, that the RQA puts back into the pool. That would come out of the blend price.

And the producers who would be benefited would be the quota holders in RFA areas. The producers who would be harmed would be over based producers. And certainly that's not a result that should be done lightly or without serious discussion.

The RQA issue is an inner-producer issue. Very clearly there's been a commitment that changes in RQAs would require a referendum. That points to the fact that the RQAs are an issue amongst producers. We've been operating under the current $1.70 rules for some time now. And, you know, approaching the decade, I think nine years. And there's a already discussions amongst producers that, you know, we need to take another look. Is the $1.70 an appropriate number in today's environment? And in the context of that discussion, certainly RQA's become part of the discussion and very relevant in terms of this hearing, and at this time, even though I know they are within the call hearing, there's been no proposal to change them other than the letter from Mr. Horton.

And I'd urge the Department to leave the RQA issue alone at this point.

I'd be happy to answer any questions.

HEARING OFFICER ESTES: Do we have panel questions Mr. Vanden Heuvel?

SENIOR AGRICULTURAL ECONOMIST ERBA: I have a couple.

Mr. Vanden Heuvel, you said that under your proposal the Class 1 usage ought to be used to prorate the allowances.

MR. VANDEN HEUVEL: Yes.

SENIOR AGRICULTURAL ECONOMIST ERBA: And would you agree that Class 2 and 3 are higher value uses of milk? And if so, why wouldn't you also include those to prorate your allowances?

MR. VANDEN HEUVEL: Well, the problem is is that, you know, you get to a point of diminishing return. Particularly, I mean under their scenario, to the extent that Class 3 and even some Class 4 would get it, the benefit to the producers is almost nil, because it almost -- the total upcharged value of that Class 3 is going to pay the transportation allowance.

And so I think it's very difficult to make the claim that some how or another producers have some obligation to subsidize all of the increase. They'd be better of to have milk essentially stay in the valley and turned into butter and powder.

And I think that's really the point. And when I look at the trend that Dr. Gruebele seems to be going, eliminating shortfalls, I'm wondering -- I mean at what point in time is it the market's responsibility to shoulder some of these transportation costs. And I think that's very, very -- it's very clear that under Class 1, the differential is sufficient to justify that producers ought to be willing to provide a transportation incentive system to make sure that Class 1 is supplied.

But I think the question gets much foggier on 2 and very foggy on 3. And the standard we have is if once you hit the 50 percent threshold, even Class 4 would receive -- in that plan, would receive transportation allowances. And I think that's really difficult to justify.

SENIOR AGRICULTURAL ECONOMIST ERBA: I have two other questions and they're sort of related. You mentioned -- Dr. Gruebele mentioned and you mentioned about some producers who are in the high desert and Kern county who are essentially making money on these allowances. And I don't know if you realize, but if you look at the milk movements and how milk was moving into southern California every month, it's almost a continuum of mileage. There's really no good way to draw a line and say at this point the mileage -- this mileage racket ends and we're going to make a change in the rates.

So I don't know if there's a way to draw a line where somebody is not going to benefit from the system. Are we missing something that you're aware of in terms of how you can set this up?

MR. VANDEN HEUVEL: Well, I think your point is well taken, that it's never -- and Dr. Gruebele acknowledged, that you're never going to get it perfect, and you're not. The question is can we do better than what we're doing?

And I think we've got some examples, that, yes, we can do better. Now, I think in this high desert case there's a couple of things that, you know, that are worth noting. First of all, from the producers standpoint, while it may be irritating that someone has a better deal than another. That is a problem.

In terms of fulfilling what our responsibility is, which is to see to it that the Class 1 -- if it costs us .43 cents from point A and .43 cents point B, and then the same distance away, you know, I think it's -- hey, obviously in, you know, looking at some other of these documents that may come into the hearing later, you know, the high desert -- there's a hauler up in the high desert who does it very competitively.

I mean, I think that's a very fair question. How can one hauler haul it from Barstow to Los Angeles for, you know, .15 cents less than a hauler can haul it from Kern county to Los Angeles at least observing, you've got the same amount of traffic congestion, the same amount of distance, you've both got a mountain pass to go over.

And, you know, so there's some of these factors that are not totally explainable.

But one of the ways you do eliminate abuses is by capping it. And I think one of the things that's becoming clear from listening to Dr. Gruebele, is that maybe the.58 cents -- I mean, whether you adopt that proposal or not, .58 cents appears to be that we don't need milk from Tulare county to come to Los Angeles.

There's plenty of mill in Kern south to take care of it. And the only reason I find it fascinating Dr. Gruebele sites as his justification for why we need to bring Tulare milk, because we've got Tulare milk coming. But then he acknowledges that there's a lot of Kern milk going to Tulare.

Well, I mean the reason you end up with these absurdities is that people are very creative and the Department does its best job to create rules. And then everybody does the best job that they can of exploiting those rules for their own benefit.

And, you know, we could probably eliminate a lot of problems just eliminate the whole .58 cent category, capping it at .43, and moving on. The plant to plant credit is another issue. But it seems to me this is a lost cause. I will tell you as a producer, I'm not willing to give Land O' Lakes an open checkbook and say whatever it takes you to move plant to plant milk, from Tulare to your buyer is what I'm willing to pay. That's unreasonable, and ought not to be sanctioned by the Department of Food and Agriculture.

SENIOR AGRICULTURAL ECONOMIST ERBA: To follow up on that question I asked earlier, the mileage brackets you proposed are very neat, and they follow an order. And that's very nice, except that when you do actually make it, it doesn't work all that well. So would you be willing to change that mileage brackets to fit with what's there rather than having it be neat.

MR. VANDEN HEUVEL: Absolutely. And, you know, we don't have the benefit because a lot of this would be proprietary knowing how those things would break out. And so, you know, in trying to find -- you know, in some ways we're inviting this question by having them in nice 25 mile brackets. And hopefully the Department would be willing to fine tune that.

But also our concern was that it appears that the northern California situation works for the people in the north. And so we were trying to come up with brackets that would not significantly disturb the north in terms of their current arrangements.

But I do think it's important to note that, you know, in our proposal, we made a similar proposal in 2001 to this. We had 0 to 15 miles at no charge. The other department maintained its 0 mileage bracket for the other 4 receiving areas.

So we look at that and say well, you know, trying to understand where the Department would like to go, recognizing that, you know, the policy changes happen in steps, it looked like starting at 0 miles did maintain some incentive for people serving Class 1. So that's why we have a 0 to 15 of the nickel, because it does meet that goal that the hearing panel had laid out.

But we certainly would have no problem with the Department using the information that you have to fine tune and polish these. I think the key point we would make is that it needs to be capped. Once you've got a reasonable supply, definition of reasonable is probably in the eye of the beholder.

But just looking at Dr. Gruebele's point that because 55 percent or 50 percent or whatever the milk in southern California comes from the Tulare county that that somehow is evidence that the current program is right, I think that that's significant evidence that there's some adjustments that need to be made.

SENIOR AGRICULTURAL ECONOMIST ERBA: Thank you.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: Mr. Vanden Heuvel, you commented or made the statement a couple of times, you're not trying to disturb the north.

Are you insinuating by that that you're comfortable with the way the transportation allowances are calculated currently for northern California plants?

MR. VANDEN HEUVEL: Well, I'm not particularly aware, but, you know, it's of how all of that works. But you, know the evidence we have and the information we have is from reading where the mileage brackets were that the Department has historically placed in those areas. And, you know -- and then go into industry meetings and not hearing a lot of discomfort or unhappiness about the northern situation.

I mean, obviously, Dr. Gruebele's concerns with southern California, our concern is with southern California primarily.

DAIRY MARKETING BRANCH CHIEF IKARI: Can I ask a follow-up question to that? Would you be opposed or supportive if the Department largely left northern California alone and just adjusted ranch to plant allowances in southern California?

MR. VANDEN HEUVEL: Yeah. You know, I think we're looking for progress. And we really appreciated the Department's willingness to tackle this issue in industry meetings in 2000. And we participated and tried to make progress with you on that. And, you know, 2001 we made a few changes. We learned that some of these things had some unintended consequences. That always will happen.

We're looking for progress. We're trying to be constructive in giving you a proposal here that you can work with that the industry can work with to move us closer to the goals that the hearing panel laid out, I think, very clearly, very accurately a couple of years ago.

So yeah, you know, it's your call based on what you hear in this hearing. We certainly would appreciate whatever progress can be made.

DAIRY MARKETING BRANCH CHIEF IKARI: I have one other question. And that is Geof, I wonder if you could spend a few minutes and elaborate on how you came up with -- how much did you look at hauling rates, local areas current ranch to plant allowances in northern California or other parts of the State, to come up with what you came up with?

MR. VANDEN HEUVEL: Well, I took where the northern California's were and tried to approximate where they were so that they fit pretty close. And in your analysis it looks like we got fairly close. By and large, north is not too much different than where they're currently at.

In the south, you know, our knowledge is you've got a Chino milk supply serving L A. And by and large anecdotally some of it shows up in your hauling reports, to haul milk from Chino to LA is, you know, .33 to .35 cents.

But to haul milk from Chino to Corona is about, you know, .25 cents, so there's your dime. San Jacinto is just a little bit further out. And so that -- you know, we picked numbers that boar some relationship to that we were familiar with. And that's kind of how we came up with it. And how you tweak it inside of that, you know, with better information you could probably fine tune it.

I think, you know, there'd have to be a pretty strong justification to go over .45 cents for southern California on ranch to plant.

I mean, it seems to me with 283 percent of supply versus demand for Class 1, you know, and that includes the 2.6 billion, I think, includes the Riverside plants also for transportation allowances.

I've got a hard time understanding how you've got to go draw that circle even bigger to get more milk encompassed. So the cap is more important, I think, to us than the internal numbers.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: Mr. Vanden Heuvel, I get the impression that one of your concerns is the volume of non-Class 1 milk that is being moved using the transportation allowance system.

MR. VANDEN HEUVEL: That is one of our concerns, yes.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: Could that concern be addressed by perhaps changing the percentage that a plant has to manufacture in a non 4A/4B?

MR. VANDEN HEUVEL: It certainly could. Yeah, there's probably other ways. You know, you could address that in any number of ways. You know, we're trying to present our proposal based on principles. And it's a pretty good principle, and it's a principle that applies to transportation credits. Credits only apply to Class 1. So it's not without some precedent, and without some history. And so that was the direction we took.

Certainly if you raise that percent or kind of that baseline, you know, to some number higher than 50, that would be a tightening. But I think you still run into the situation where, you know, we are subsidizing and getting very little return for those non-Class 1 uses.

Clearly, 50 percent, at least in our view, is way too low of a threshold.

AGRICULTURE ECONOMIST GOSSARD: I have a couple questions. On the third page of your testimony, you're talking about the transportation credits. And basically under your proposal the transportation credits would be equivalent to your transportation allowances under equivalent distances.

MR. VANDEN HEUVEL: That's our intent. And there's a number of different ways to interpret that. And we would certainly -- you know, and we appreciate the Department's, in the last hearing, going in this direction of setting the appropriate transportation allowance and then making an attempt to set a credit in this direction. And we applaud you for that, and thank you for that, and we defer to you.

If you buy the principle but you find a better way to fine tune it, and then do it, then we'd appreciate that.

AGRICULTURE ECONOMIST GOSSARD: Because in the

Department's analysis, of your proposal, given that the plant to plant moves less total volume, there is actually the total amount taken from the pool to move equivalent milk would actually be more under your allowance system and less under the equivalent credit. Is that you're intent or are you looking for --

MR. VANDEN HEUVEL: No, it's not our intent that we penalize transportation credits. Our intent is what do we say it is, which is to give them the opportunity to move the plant to plant or at least give the, you know, be willing to pay an equivalent amount. And how that's determined you know, we definitely defer to the Department if you buy the principle to fine tune the language to produce that result.

AGRICULTURE ECONOMIST GOSSARD: Finally, at the top of the third page you say for southern California the cap is particularly relevant. In your current cap I believe it's .45 cents.

Do you think it's a good concept to have sort of a one cap fits all -- while cents might be appropriate for southern California. It certainly is much higher than the Kern County and going into Sacramento, which is .12 cents.

MR. VANDEN HEUVEL: I think that's a very good point. That's a good point. And, you know, sometimes, you know, you go into a hearing with a proposal and you haven't got the benefit of everybody's thinking. That's why we have hearings. But a .45 cent cap makes sense in southern California and that's where we are primarily focused.

But you're right, it may not make any sense in some of the other receiving areas. And if we stay with a receiving area concept, then a different cap may be more appropriate in those other receiving areas.

AGRICULTURE ECONOMIST GOSSARD: Thank you very much.

HEARING OFFICER ESTES: Thank you very much, Mr. Vanden Heuvel.

MR. VANDEN HEUVEL: Thank you.

HEARING OFFICER ESTES: We'll proceed with public testimony at this time.

Members of the public will now testify with each speaker providing up to 20 minutes, followed by questions from the panel.

To assure the accuracy of today's hearing record I will basically swear each witness in and ask for various types of information related to how your testimony was finalized and developed.

We have a list that's being developed in the back. If you're here today and you wanted to testify and you have not yet signed in, please do so. Currently we have, I believe, seven people who are going testify. And I'll take them in the order of that.

The first witness is William Schiek of the Dairy Institute.

DR. SCHIEK: Can you hear me?

HEARING OFFICER ESTES: All right. Would you please state your name and spell your last for the record.

DR. SCHIEK: Yeah, my name is William Schiek S-c-h-i-e-k.

(Thereupon the witness was sworn, by the hearing officer, to tell the truth and nothing but the truth.)

DR. SCHIEK: I do.

HEARING OFFICER ESTES: And please state the organization that you represent.

DR. SCHIEK: Dairy Institute of California.

HEARING OFFICER ESTES: And the number of members in the organization?

DR. SCHIEK: About forty dairy companies.

HEARING OFFICER ESTES: And the process by which your testimony was developed?

DR. SCHIEK: Our testimony was developed through our Producer Relations Committee, which is our Policy Committee, and then adopted unanimously by our Board of Directors.

HEARING OFFICER ESTES: I see we have a written copy of your statement, proposed testimony today. Would you like to enter that into the record?

DR. SCHIEK: Yes, I would.

HEARING OFFICER ESTES: It will be introduced in the record as Exhibit Number 66.

(Thereupon the above-referenced document was marked by the hearing officer as Exhibit 66.)

HEARING OFFICER ESTES: So please proceed with your testimony.

DR. SCHIEK: Okay. Mr. Hearing Officer and members of the hearing panel. My name is William Schiek. I'm the economist for Dairy Institute of California, and I am testifying on the Institute's behalf.

As I said, Dairy Institute is a trade association representing 40 dairy companies, processing approximately 75 percent of the fluid milk, cultured, and frozen products, over 60 percent of the cheese products, and a small percentage of butter and nonfat milk powder processed and manufactured in the state.

Our member firms operate in both marketing areas in the State. And the position that I'm presenting at this hearing was adopted unanimously by Dairy Institute's Board of Directors.

Dairy Institute appreciates the opportunity to testify today and to comment on the proposals by Land O' Lakes and Milk Producers Council, which are under run consideration at this hearing. We commend the Secretary for his willingness to consider updating the regulatory framework in which our members operate to make it reflective of current market conditions.

We appreciate the excellent work and tremendous effort put forth by the Department's staff in preparation for this and other hearings. We all benefit from the data and analysis that the Department provides, as it helps us to make better informed decisions regarding the policy we propose.

However, we would like to suggest that future hearings deal with milk movement issues be managed differently. Given that milk movement issues are complex and that a great deal of Department-generated information must be made available to industry participants in order for them to formulate proposals that make sense given current transportation structures and market conditions, adequate time should be given for participants to both analyze the data provided by the Department and to submit their proposals. Updated hauling rate information was made available two weeks ago, and much of the information presented by the Department at the pre-hearing workshop would have been useful in advance of the proposal submission deadline. We understand and appreciate the fact that getting the data assembled takes time. In the future, the Department should endeavor to make alternative proposal deadlines fall after the Department's information becomes available so that it could be taken into account when we are formulating our positions.

For example, with respect to this hearing, the hearing date could have been put off until mid-July and proposals could have been due in mid-June. Under such a timetable, we could have better utilized the information that was made available on May 22nd at the workshop.

These comments are not intended to be critical of the Department's staff, as we understand the effort and time involved in putting together all the essential data. Rather, they should be viewed as a suggestion that would benefit all hearing participants and lead to a better hearing record.

At issue in this hearing are proposed changes to the milk movement incentives contained in the pooling plan and stabilization and marketing plan for the northern and southern California marketing areas. In corporation with producer representatives, Dairy Institute has had an active role over the past 22 years in the development of the transportation allowance systems for ranch-to-plant movements of market milk, as well as the development of a transportation credit system for plant-to-plant shipments of milk into northern and southern California deficit areas.

Over the years, Dairy Institute has supported the maintenance of the milk movement requirements or "call provisions" to ensure the Class 1 markets get served, as well as the regional quota adjusters as a means of maintaining a linkage between the cost of serving Class 1 markets and the higher share of Class 1 revenues that quota holders receive.

The broad purposes of milk movement programs have been identified as follows:

First, to assure an adequate supply of milk to plants which provide Class 1 and Class 2 usage products to consumers;

Second, to assure that higher usages (Class 1, 2, and 3) have priority in terms of milk movement incentives to producers; and,

Thirdly, to encourage the most efficient movement of milk to fluid usage plants.

The enactment of milk pooling in 1969 fundamentally altered the relationship between Class 1 processors and suppliers. Prior to pooling, the higher "plant blend" price that was paid by Class 1 plants provided a positive incentive to attract milk to the highest use.

During the discussions leading up to the Gonsalves Milk Pooling Act, producer representatives, in exchange for processor support, made a commitment to ensure that Class 1 plants would be served. From the beginning it was recognized that fluid plants, by virtue of the higher minimum prices they pay, should be able to procure necessary milk supplies without having to subsidize the haul cost to their plants.

The current system of transportation allowances and credits in California developed after a period where milk movement incentives were limited primarily to the area differentials (plant-to-plant milk shipments) and the location differentials on quote milk, a system which was not unlike the location differentials employed in federal orders.

Over time, the consolidation of the marketing areas, growth in milk production, changing production and distribution patterns, and unique California geography necessitated new milk movement mechanisms.

The transportation credits and allowances both came into being in the early 1980s. The general principle behind transportation allowances was that they should compensate dairymen for the difference between the local haul to a manufacturing plant and the long haul to the more distant fluid milk plant in a metropolitan area. In the absence of such incentives, producers would have an incentive to ship their milk to the manufacturing plant, and a disincentive to serve the more distant fluid milk market.

When the transportation allowance fully compensates producers for the difference between the local haul and the long haul to the fluid plant, the producer will be indifferent to where he ships his milk.

With respect to transportation credits, the principle was to compensate the milk supplier for the cost of shipping milk from the supplying plant to the deficit-area plant, after accounting for any difference in the marketing area Class 1 differentials.

Historically, the transportation credits and allowances have been set at levels that do not fully compensate handlers for their shipment costs. This built-in shortfall on movements of more distant milk has been supported by Dairy Institute in the past based upon the assumption that it would encourage milk closer to deficit areas to serve the Class 1 market before the more distant milk.

As I will discuss in more detail later, the application of the shortfall concept today does not account for the current market infrastructure and procurement patterns, and creates a disincentive for some plants per California milk for Class 1 purposes.

We continue to believe that a milk movement incentive system is necessary in order to meet the statutory mandates and guidelines governing our industry. In recent years, the industry has continued to evolve and has undergone considerable structural change. Consolidation of supplying cooperatives and fluid milk processors has changed the milk production and distribution patterns. It is therefore appropriate to review existing systems of transportation allowances and credits to determine if changes are necessary.

One trend that has been troubling to Dairy Institute's membership has been the increasing need to rely on over-order premiums as a means to attract milk for fluid purposes. We believe that it is consistent with the purposes of milk stabilization, and with the commitments made by producer leadership at the inception milk pooling, that milk should be attracted to Class 1 plants at order prices. Unfortunately, some in the producer community have held the incorrect view that the sole purpose of the Class 1 price differential is to enhance producer income, rather than recognizing that, in part, its level was designed to assure that Class 1 markets are served.

We continue to maintain that the existing order prices paid by processors provide more than enough revenue to attract milk for Class 1 and mandatory Class 2 purposes, and that the marketing and pooling plans should provide milk movement incentive mechanisms which are adequate to ensure that those uses are served.

Our general concerns with respect to Dairy Institute's positions, we believe that transpiration allowances and credits must be adequate to encourage milk to move to higher-use plants in deficit areas.

When rates are not adequate, either the supplier or the customer gets stuck with the transportation bill. Milk suppliers and processing plants operate in a competitive environment. Suppliers can attempt to absorb these unrecovered transportation costs in the short run. But in the longer run they must either pass those costs on or stop supplying the Class 1 market. If they choose to pass the costs on to the processor, the higher-use plant must then decide whether to accept the higher costs or look to other sources of milk.

If all processors are facing the same regulated price and all suppliers are attempting to pass on the unrecovered transportation costs, processors might elect to subsidize the transportation of milk to their plants and pay the higher costs. However, when processors face unequal regulated milk prices relative to their competitors, as in the case in southern California with exempt producer distributors and unregulated out-of-state milk bottling plants, processors might attempt to find less expensive milk supplies, such as those located outside the state.

Hence, inadequate transportation allowance and credit rates can lead to Class 1 markets being served by out-of-state suppliers to the detriment of the California pool. Inadequate rates also lead to California Class 1 processors being both unable to compete favorably with manufacturing plants for milk supplies and at a competitive disadvantage with respect to out-of-state processors. In order to secure the local Class 1 market for California producers, transpiration allowances and credits must be adequate to draw milk without transportation subsidization by the buyer or the supplying cooperative.

Transportation allowances. Dairy Institute continues to support the principle that transpiration allowance rates should be set equal to the difference between the cost of the local haul and the cost of a haul to a higher-use plant in metropolitan markets. A slight shortfall should apply to the most distant mileage brackets to encourage milk that is located closer to the market to move first. The mileage brackets should be constructed so that enough milk moves to satisfy fluid milk requirements and that compensation rates are adequate to sufficient numbers of producers.

Dairy Institute supports adjustments to the allowance rates proposed by the petitioner because the current allowance rates provide more money than is needed for some milk to move to southern California plants. Dairy Institute members could see no reason to exclude Fresno County from the eligible supply counties for transportation allowances on shipments into southern California.

Again, we adopted our position prior to the hearing workshop, and it was based on the initial petition from Land O' Lakes, and we didn't see a lot of justification for the elimination of counties. If there were a compelling reason, we might have reached a different result. But at the time we just couldn't see the reason. And in the absence of a compelling reason to eliminate Fresno County, we oppose this particular aspect of petitioner's.

Dairy Institute opposes the MPC proposal with respect to transpiration allowances. While we agree in principle that nearby milk should be encouraged to move to Class 1 uses ahead of more distant milk, we believe that the existing structure of the industry in southern California would result in MPC's proposal being ineffective at altering milk procurement patterns to make them more efficient. The manufacturing plant in Corona will continue to draw enough milk to keep their large operation going, and considerable quantifies of milk from the South Valley will still be needed to supply southern California's fluid needs.

MPC's proposal, given this industry structure, would give allowances to milk that would move to fluid plants anyway without the availability of such allowances. Therefore, it takes money from the pool that is not needed to encourage milk to move to higher-use plants.

The transportation allowance system was never intended to address producer equity problems or to equilibrate hauling costs among producers. It was meant to -- and historically has done so reasonably well -- address the narrow problems of how to attract milk to fluid plants in metropolitan areas at order prices. Producer equity issues are addressed through the pool and through the computation of pool prices. Allowances and credits are not intended, nor should they be, to promote equity by making rates available to producers who would serve the Class 1 market anyway.

The MPC proposal for allowances on local milk in southern California, while seeming to provide an incentive to pull milk away from manufacturing plants and into fluid plants, will result in little extra milk moving from southern California to fluid plants because of the large cheese plant that is soaking up much of the milk supply -- because the large cheese plant that is soaking up much of the milk supply in southern California is a cooperative and will retain control over its members' milk.

Also, the cooperative is national in scope and has the ability to move money from other areas of the country in order to match any incentives that might be made available via transportation allowances to local producers.

Given that additional local supplies will not be available for Class 1 use in southern California despite the availability of milk movement incentives for local milk, transportation allowances must be large enough to move milk from the South Valley because such milk is needed. MPC's proposed allowance and credit rates are insufficient to encourage the necessary milk movements.

MPC's notion of making allowances available only on Class 1 use results in problems for plants that do not have 100 percent Class 1 utilization. The dilution of the allowance rates leads to an incentive that is insufficient to attract milk without additional premiums.

Allowances on Class 2 and 3 usage are justified because these products are higher valued uses. MPC's argument you plant eligibility for transportation allowances should be determined on a month-to-month basis rather than a 12-month basis is likewise problematic. On any given month a producer shipping to a plant will not know in advance how much of an allowance he will receive and cannot make informed decisions about where to ship his milk.

MPC's one-size-fits-all approach has not been supported by processors or major cooperatives in the past. Prior hearing decisions have confirmed the uniqueness of different local markets and the differing rates on allowances and credits that are necessary to move milk. MPC's approach may indeed by simpler and it may reward a particular group of producers who serve the Class 1 market, but it does not serve the primary purpose of the allowance and credit system, which is just to ensure that higher-use plants are served.

Dairy Institute does not believe that MPC can prove that their proposal would result in Class 1 markets being served in a more efficient manner without causing Class 1 plants to have to subsidize the transportation of milk to their plants. We urge the rejection of MPC's transportation allowance proposal for all the reasons listed above.

Transportation credits. Dairy Institute supports the LOL-proposed adjustments to the credits and allowances for bulk milk to the extent that they are cost justified. Shortfalls in credit rates should only be employed for the most distant milk, and not for milk in relatively closer areas that regularly serve the southern California Class 1 market.

Dairy Institute does not support the extension of transportation credits to condensed skim because there was not adequate time to fully examine the impacts of such an extension. The proposal might make economic sense. But because condensed skim procurement for fortification is not associated with traditional supply areas or milk sheds and because there is diversity in how plants deal with the fortification requirement, Dairy Institute is opposing transportation credits for condensed skim until we have a more detailed analysis of the impacts of the proposal. Dairy Institute opposes the MPC transportation credit proposal because it would reduce credit rates and provide inadequate incentives to move needed milk on a plant-to-plant basis.

Plant-to-plant versus ranch-to-plant milk movements. In recent hearing decisions, the Department has focused on maintaining a level playing field between transportation allowances and credits. Rather than worry about getting equivalent rates between transportation credits and transportation allowances, the Department should focus on the amount of money that it takes to get the milk to move under each type of incentive. For transportation allowances, it is the difference between local haul and the long haul to the deficit area plant, because the producers would incur the local haul under any circumstances. For transportation credits, it is the cost of the plant-to-plant haul, less any area class price differential. The appropriate question for the Department to address pertains to what it takes to get milk to move under each type of incentive, not how we keep the rates roughly equal for both types of incentives.

The Department's concerns seem to infer that if transportation credits are set at levels that fully compensate the supplier for the hauling cost, the greater efficiencies of using transportation credits will encourage plant-to-plant milk movements to the exclusion of ranch-to-plant milk movements. We do not believe that this will be the case. There is a need for both types of milk movements.

Ranch-to-plant movements provide the full set of components, and some of the fat that is not needed for bottling can be utilized in the other products the plant produces. However, exclusive use of ranch-to-plant milk movements may burden some plants that have only limited ability to utilize the fat that is not needed for bottling.

Plant-to-plant movements are needed because they provide a complementary way to move milk without moving all the excess fat that is associated with producer milk.

Bottling plants will often need loads of skim to supplement their ranch-to-plant supply in order to provide the type of milk that consumers demand.

Transportation credit rates must reimburse for the cost of the plant-to-plant haul. It has been previously argued that adequate transportation credit rates, as we have defined them, give too large a cost advantage to plants that receive "tailored" milk; that is, milk that has already been blended to a standard composition for consumer packaging.

In the case of tailored milk moving plant to plant, the tailoring is a service for which the buyer pays extra money through a service charge levied by the supplier. Therefore, the pool is not directly subsidizing the tailoring of milk for customers, as some have suggested. The bottom line here is that when transportation credits and allowances are set at rates that are sufficient to encourage both types of milk to move to higher-use plants, the playing field is level from our perspective.

Call provisions. Dairy Institute supports the continuation of the call provisions. Under these provisions, handlers are given incentive to voluntarily supply milk for fluid uses when call provisions are implemented. The existence of the call provisions promotes supply handlers building business relationships with fluid customers to voluntarily release market milk such that both the seller and the buyer can better plan such milk shipments. Without the call provisions, supply handlers have less incentive to build such ongoing relationships, which could exacerbate disorderly and chaotic milk movements in emergency short supply situations.

Dairy markets are unpredictable and the call provisions are necessary as a standby mechanism should they be rapidly and unexpectedly needed. Unanticipated weather conditions, rapidly changing manufactured product prices, and cost/price squeezes have caused sudden changes in milk production patterns in the past, and the call the provisions have helped maintain milk supply availability. The call provisions are the only means within the marketing and pooling system to make quota milk available for priority uses.

Regional quota adjusters. Dairy Institute supports continuation of the regional quota adjusters on the grounds that our membership believes that quota holders have an obligation to ensure that Class 1 markets are served. RQAs provide, albeit indirectly, pool revenues that are available to fund transportation allowances and credits. We do not support changes in RQAs at this time.

Thank you for the opportunity to testify. I'm willing to answer any questions you have at this time. But I would also like to request the opportunity to file a post-hearing brief.

HEARING OFFICER ESTES: All right. All the requests for post-hearing briefs today are granted, obviously.

The panel, do you have any questions for Dr. Schiek?

SENIOR AGRICULTURAL ECONOMIST ERBA: Dr. Schiek, are the eligibility requirements for plants receiving transportation allowances adequate or do they need adjustments?

DR. SCHIEK: The eligibility requirements -- just what requirements specifically?

SENIOR AGRICULTURAL ECONOMIST ERBA: The percentage of Class 1, 2, and 3 must be processed.

DR. SCHIEK: The short answer is: I don't know exactly. I don't have a strong opinion. But I would say, as a principle, that level should be set so that most of the plants that process Class 1 products -- a majority of Class 1 products in the state are covered and have access to the allowances in deficit -- if they're located in deficit areas.

I think kind of looking at the data and seeing where there's a logical break point might suggest whether or not it could be moved up or whether it needs to stay where it is.

SENIOR AGRICULTURAL ECONOMIST ERBA: What about additional requirements for, say, establishing a maximum that must be and can be processed in the Class 4 products?

DR. SCHIEK: Again, you know, I -- obviously the intent of the allowances is to move them and make sure the milk gets moved to higher priority uses.

I suppose if you had a plant that was 51 percent Class 1 and 49 percent Class 4A, if it was a big plant you could argue, "Hey, that's a lot of Class 1 use, and it should be served." What I don't know is -- as you can necessarily take a percentage number and apply it in all cases.

Our feeling is that the current level works pretty well and there doesn't appear to be a need to change it.

SENIOR AGRICULTURAL ECONOMIST ERBA: One other question.

Do producers in your opinion have an obligation for the secondary hauler of the milk, that is, the plant-to-plant hauler? Are they responsible for getting the milk to the first -- that first receipt? Are they also responsible for moving that milk further in that the pool provides a subsidy for that currently?

DR. SCHIEK: I think the argument is that they're responsible to serve the Class 1 market. And by virtue of the fact that the higher-used markets add money to the pool, and by virtue of the fact that most Class 1 plants would not be able to utilize exclusively ranch-to-plant milk, the market has evolved over time such that consumers demand lower fat fluid milks. That's the Class 1 market. In order to adequately serve that market, I guess you're asking the question, is: Who should bear the cost of making sure that the products consumers want are provided. Our feeling is producers have a stake in that. And like I say, we don't necessarily view transportation credits and allowances substitutes. We view them, you know -- as an industry, we view them as important complements in order to serve the market in a way it needs to be served.

SENIOR AGRICULTURAL ECONOMIST ERBA: Thank you.

DAIRY MARKETING BRANCH CHIEF IKARI: Let me follow up on that question.

Surely there's been discussions within the Dairy Institute about those plants who can take milk from the farm and absorb the cost of taking the extra fat versus plants who get all their milk tailored. And there -- I would assume that there's some competitive issues there among processors.

DR. SCHIEK: There are and have been competitive concerns in the past about where those rates are. I think the -- you know, the thing that happens is over time market structure and market procurement patterns change. And I think where people are coming from now -- and as a point I tried to make in my testimony -- is that there are a lot of competitive pressures; and if plants find themselves having to subsidize the call to the plant, there are incentives to look for any ways you can to, you know, eliminate those costs. And some plants have chosen to obtain those supplies from out of state, which I don't think serves producers very well. But it happens because incentives are there to do it.

And to the extent that allowance and credit rates do not fully compensate and require somebody to subsidize that, some -- either the supplier but longer term -- the buyer to subsidize that, they're going to look to other sources in order to be competitive. So I think that's more of an overriding concern.

And the other thing I would point out is that, you know, tailoring of milk. Plants who have received tailored milk may get some efficiency gains from that. But on the other hand that's also a service that a cooperative supplier provides, and it's an added -- value-added service and the plants are charged for that service.

Now, the question I guess would be whether the charge -- service charge outweighs the efficiency gain or balances the efficiency gain. And I don't know the answer to that.

DAIRY MARKETING BRANCH CHIEF IKARI: Have processors ever talked about -- setting aside the overall concern that you raise, you provided in your testimony -- as to how much is too much in terms of the transportation credit where it gives a plant an advantage? Do you have anything to share with us in terms of setting those credits?

DR. SCHIEK: Not really beyond the statements that I made here, which is that, you know, our members' Producer Relations Committee supported the notion that milk is going to have to move from the South Valley. And in the past we had argued for a shortfall from Tulare on plant-to-plant movements. I think now there's this recognition that that milk is needed, and the notion is to push the shortfall concept farther out at least to the plants to fully compensate the milk coming in from Tulare. And, again, that's because members feel that that milk is needed and should move to Class 1 plants that earned prices without transportation subsidization by the buyer.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: Mr. Schiek, on page 4 of your testimony, the very bottom, you mentioned or state, "In the absence of a compelling reason to eliminate Fresno County..." -- it goes on from there.

What about the other counties that were eliminated per the proposal?

DR. SCHIEK: Yeah. Well, again, I should point out that position that was adopted by our Policy Committee came out when the first Land O' Lakes petition came out. And I guess we weren't clear exactly which counties were being excluded at that point, but it's clear Fresno County was. But I think the general feeling was that unless there's a good reason, like the system's being abused, then why exclude the counties. That's kind of where they were coming from.

Now, you know, if presented with evidence that a system is being abused and that the stress milk that can't find a manufacturing home that's located in northern

California is being shipped down all the way to southern California with a credit -- or with an allowance, you know, I would guess that the members would have looked differently upon that situation, that the allowances and credits really aren't intended to handle the stress from northern California by guiding it into southern California Class 1 plants. But we didn't discuss that, and the board did not take a position on that, because that wasn't the information that we had at the time.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: Also in your testimony you indicate that California plants have looked for sources of milk outside of California. And I don't recall exactly where it's at. But you suggested that milk in a cheaper source of milk for your members.

All milk, regardless of whether it's -- regardless of the source accounts to the pool at the Class 1 price.

DR. SCHIEK: Right.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: And then there is credits for that milk depending upon its origin.

DR. SCHIEK: Right.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: In order for that milk to be cheaper, I'm assuming that the plant is either 1) paying less for that milk than the pool credit or 2) they are paying a lower premium.

Do you have any idea which would be the case?

DR. SCHIEK: My understanding, based on conversations with members and folks in the industry, is that the milk coming in from out of state is available at a lower premium. And, again, my understanding -- and, you know, this is -- again, I don't claim to have perfect knowledge on this -- but that premiums that were being levied by or asked for by some in-state suppliers were due in part to the fact that there were some unrecovered costs, costs that they couldn't recover in the system, whether it be transportation. It may be that they -- the services they were providing they weren't equally compensated either. I don't know. But I do believe that the transportation rate allowances and credit rate played a role in that.

So in order to supply that market without eating a lot of money or taking a loss, they would have to try to pass that cost on to their customers. And the customers are not trying to get around paying the Class 1 price, but they're looking at the premium structure and they're seeing other milk that's available without the same premium structure. And it's attractive, particularly again when you're competing against exempt PDs and there are now potentially unregulated out of state.

AGRICULTURE ECONOMIST GOSSARD: Mr. Schiek, at the beginning of your testimony you expressed an interest in having a different format for milk movement to set up hearings. Would you then envision sort of two workshops, an initial workshop, one that presents background material, interested parties use that background material to generate alternative proposals, followed by a second workshop which covers the analysis of the alternative proposals as to whatever positions you seek?

DR. SCHIEK: Yeah, essentially what I'm proposing. And I know that means more work for you guys because you have to do two workshops. But, again, I think the nature of milk movement requires just, you know, reams of information that most of us don't have access to on our own resources. And some of the larger cooperatives, you know, because they know where the producers are and they know where to ship the milk, they have a good piece of that. But a lot of us don't -- we only what the Department's able to provide for us.

And, you know, the hauling rate charts are kind of an essential piece. They give us an idea of whether things are in the ball park or not with regard to credits and allowances with regard to cost.

So I mean our point -- and, again, I understand that -- you know, I'm not saying the data should have been available earlier. I'm saying the hearing should have been constructed so that we could have done our proposals after the data was available. And the idea of having an informational presentation where you give us the data, and then a pre-hearing workshop where proposals are analyzed, would be a good way to handle that.

And I think you folks would benefit as well because I think you'd end up with better proposals and a better hearing record because of it.

AGRICULTURE ECONOMIST GOSSARD: Would another alternative -- much of that background material could just be published on an annual basis. If that was made available on a annual basis, would that be of assistance?

DR. SCHIEK: That would be of assistance, certainly, as well.

You know, and other things that would be helpful -- since I have the platform here -- is that, you know, when we do analysis of the proposals, they tend to be static analysis, which is, you know, what we have the ability to do. But I think the knowledge base is there that we could put an industry study committee together to build a transportation model of the California dairy industry where we could actually analyze dynamic impacts; that is, when you make changes in allowance rates, you know, there's often a change in where milk flows from.

You know, right how we tend to look at what the milk distribution pattern was. And now we've got new rates, how much would that have cost or saved. But in reality, when you change rates, there's economic incentives for milk movements to move around. And it would not be a terribly difficult thing with the knowledge base of the Department and industry to put together a model where those changes would be analyzed. And, again, that would improve the hearing record a lot and make for better informed policy decisions.

AGRICULTURE ECONOMIST GOSSARD: Going on. And you had both the specific pages, but in pages 2 and 3 you talk about the need to move milk. And in some places you talk about the Class 1 and 2 usage, in other places 1, 2 and 3, and sometimes you just talk about fluid usage, Class 1. And this gets a little to the Milk Producers Council proposal. Right now, the credits are just geared to Class 1. And the allowances treat Class 1, 2 and 3 equally.

Is that the appropriate weight? Should more weight be given to milk moving to 1 or 1 and 2 or 3?

DR. SCHIEK: Yeah. Well, yeah, I understand where you're coming from.

Class 1 and 2 -- you know, I tend to think of Class 1 and mandatory Class 2 use, there's a requirement that those monies be pooled. And I think you could think of those as -- you know, because there's requirement that they be pooled, I think you can think of those as usages that should be served.

I think part of what we run into here is that the goal is primarily to attract milk for fluid use, primarily. But historically Class 1 plants have produced a lot of other products in addition to the bottling. And we still have quite a few Class 1 processors today who make yogurt and ice cream, any number of other higher use products.

And I think it gets to the point of, if you're going to provide a transportation allowance, which is made available to producers who ship to a given plant, if you make it only available to Class 1, either processor or a state is put in a situation where you assign certain producers to Class 1 usage and others to Class 2 and 3, which, you know, generally is a difficult and untenable situation because that's supposedly what pooling is meant to eliminating.

Or you kind of give an average prorated rate, which now is suddenly not a sufficient rate to attract milk Class 1 use. It's lower than the rate that is determined we needed.

Now, I would also say that I believe that there's sense in having milk movement allowances available to any higher valued use. As long as, you know, the reimbursement rate or the a allowance rate doesn't exceed the differential to the pool, that should be okay. And under current rates I don't see that as a problem.

Mr. Vanden Heuvel stated, you know, the advantage may be pretty close to nothing. But, you know, pretty close or almost doesn't count. I mean if it's still a positive contribution to the pool, then I still think it's valid.

AGRICULTURE ECONOMIST GOSSARD: On the bottom of page 3 you say one trend that has been troubling the Dairy Institute's membership has been the increasing need to rely on over-order premiums as a means to attract milk for fluid purposes.

At the last hearing the Department held earlier this year, there was some discussion about the fact that if the Class 4B price was raised, the Hilmar cheese plant might be paying smaller over-order premiums to its members, which might change the over-order premium system for the plants -- Class 1 plants in southern California competing for the same health supply.

To what extent is the Department responsible for paying the subsidy for milk movement and to what extent are we not responsible for dealing with competitive situations?

DR. SCHIEK: That's a very good question, a thoughtful one. If you'll give me a minute to think about the answer.

Your point is well taken. I guess the issue is should the Department be responsible for making Class 1 plants competitive with manufacturing plants who are out there paying premiums based on the fact that they're able to generate higher values through their plants, through the products they produce.

I would argue that to some extent their ability to do that, manufacturing plants' ability to pay those premiums was due to pooling. And in days before pooling, Class 1 processors had a higher price and had no trouble attracting milk. So, I think there is some validity to the pool addressing those concerns.

On the other hand, what we're talking about here today is really primarily the transportation. You may recall that prior to the last hearing, at the series of workshops the Department had, we floated a concept of a Class 1 incentive.

In reality, I don't think we saw that as a direct replacement for allowances and credits, which deal primarily with transportation, but as the incentive as a means of dealing with, in fact, that there's all these premium structures out there in the market place from the manufacturing side.

And, you know it's a complex issue. I don't pretend to say the answer is simple, because we've got different goals at work here. On the one hand you could -- you've mentioned that the 4B price being raised may have impacted the ability of cheese plants to pay premiums. And to some extent that may accomplish some purposes on the Class 1 side. On the other hand, we want to have adequate manufacturing capacity in the state so we don't have the distressed milk trying to move all the way into southern California from northern California.

So I think, you know, again, it's a balancing issue.

AGRICULTURE ECONOMIST GOSSARD: In the bottom of page 4: "The Dairy Institute supports adjustments to the allowance rates proposed by the petitioner."

With the exception that you already discussed of -- that definitely you didn't want to exclude northern California, but you didn't give clear direction to your board as to whether it's not to exclude the rest of northern -- I mean not to exclude Fresno. But you didn't give direct information for your board on the other 45 towns.

Does that mean that the Dairy Institute supports making Riverside County eligible for transportation allowances?

DR. SCHIEK: Yes, we do.

AGRICULTURE ECONOMIST GOSSARD: As in the question after Dr. Gruebele's testimony, what about the situation that would leave one Class 1 plant in southern California in San Bernardino County, it's the only Class 1 plant, without transportation allowances; would that be equitable?

DR. SCHIEK: Again, I -- if that plant requires ranch-to-plant milk movements from the South Valley, then I would argue they should be allowed to have that as well.

I don't -- I think the plant you're referring so is a producer distributor. I don't know how much outside milk it would procure. But maybe I'm thinking of the wrong plant.

So if they have all their milk needs met by their own production, then -- it's an interesting theoretical question. I don't know how much practical application in fact it has.

AGRICULTURE ECONOMIST GOSSARD: Likewise, in looking at one of the departmental exhibits, it shows relative Class 1 production. Our utilization in the county is relative to production. And in that sense, for example, Sonoma County is more of a deficit county than

Riverside County.

Wouldn't -- if Riverside County should be getting an allowance, what about Sonoma County?

DR. SCHIEK: Well, this is an issue we discussed in our Policy Committee meeting. And there are clearly some problems in the Sonoma area with regard to some -- all rates that don't appear to make sense. And we discussed this at length, that maybe this needs to be addressed. And I think the consensus of the Producer Relations Committee, and the Board backed it up, was that perhaps we need to address this with the haulers and the suppliers first before coming and trying to propose changes. It may be that at some future date we'll need to do that. But the decision was to try to see if there was another way to resolve this before coming and looking at changing rates and maybe making an allowance or eliminating the availability of getting allowances. You know, you notice when you look at the numbers for the north Bay Area, the local haul is greater than the haul into the Bay Area, which doesn't seem to make sense. I mean obviously you're moving more miles and you're moving through urban traffic to get to the Bay Area. It just doesn't make sense.

And you could try to address that through the allowance system. But if the root cause of that is some business practice that has a historical root that, you know, people have kind of sat and haven't really thought about, there might be other ways to address that problem.

AGRICULTURE ECONOMIST GOSSARD: Now, finally, the Land O' Lakes proposal would reduce the transportation allowances within southern California.

The Dairy Institute supports that as well?

DR. SCHIEK: With regard to the areas where they were talking about reducing it, the argument that they presented to us, which was that those producers would be overcompensated and had a strong incentive -- a greater incentive than was needed to supply the Class 1 market in order to get them, you know, we just found that, you know -- again, going back to the principle of the -- 1) Does the milk need allowance to get it to move? 2) The allowance rate should basically be the difference between the local haul and the long haul. And their argument to us was that that allowance rate exceeded the difference between a local and a long haul. And so we support cutting it back to the point where it does equal the difference between the local haul and the long haul.

AGRICULTURE ECONOMIST GOSSARD: Then if you apply that same principle to milk going into the Bay Area, then instead of having a single concentric circle with the current data, you would have the lower allowances coming from the north Bay into the Bay Area.

DR. SCHIEK: Right. I mean, one -- frankly, one of the things that we discussed was perhaps sort of bifurcating the supply area going into the Bay Area and having, you know, maybe no allowance from the north Bay into the Bay Area versus, you know, the valley where you -- coming from the North Valley where you still need an allowance. But, again, there's a difference between issues that are cost based, which we appeal to situation in southern California here, it's based on a cost of actually hauling that milk, versus issues that are institutionally based. I don't see how those rates could be cost based. And I think the decision was when we looked at that that there was something -- there was a better way to address it than to come, you know, and expect the state to accommodate this situation, which is -- maybe can be solved in another way.

AGRICULTURE ECONOMIST GOSSARD: On page 5 of your testimony, towards the middle, you talk about the -- third paragraph -- "The MPC proposal for allowances on local milk in southern California, while seeming to provide an incentive to pull milk away from the manufacturing plants and into fluid plants, will result in little extra milk moving from southern California to fluid plants," et cetera et cetera.

But without a dynamic programming model, that's an assumption you're making that that's what will happen?

DR. SCHIEK: It's an informed assumption.

AGRICULTURE ECONOMIST GOSSARD: Okay. Finally -- no, sorry. Two more.

On page 6 under the transportation credits --

DAIRY MARKETING BRANCH CHIEF IKARI: Tom can I ask a question?

That assumption was based on the five cents that MPC proposed -- the five-cent allowance that --

DR. SCHIEK: Yeah.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay.

DR. SCHIEK: The assumption is that, you know, you begin to give allowances to producers in southern California, is that going to pull milk away from that plant and make more southern California milk available to Class 1 market? That's the question we need to begin with.

And my informed assumption is that the cooperative operating that plant has a strong incentive to keep that plant wet for the milk, make sure they have enough milk to operate that plant efficiently. And because they're a cooperative because they have members, the sense we get is that, you know, they're not going to just say, "Okay, take our milk and we'll operate at half capacity," or whatever. "And we'll buy our milk from the South Valley area where we cannot get any transportation allowance and increase our procurement costs." We just don't think that's a likely scenario.

So MPC's proposal, you know, we think that sort of the principle behind it has some merit. But we've got to deal with the world the way it is, not the way we would like it to be; or, you know, the way it actually is and not how it should be in theory. I mean Dr. Gruebele talked about the location studies by Raymond Bressler. And when I was a graduate student in agricultural marketing, that was one of the first things we looked at in location analysis was Bressler's model of milk sheds and where plants are located. And the argument is there's never a cheese plant in an metropolitan area. Well, we have -- do we pretend it doesn't exist or do we recognize reality and kind of say what does it take to get the Class 1 market served given that reality? And that's the point.

AGRICULTURE ECONOMIST GOSSARD: On page 6 on the transportation credits, you say you support the LOL proposals. That would be both for increasing the transportation credits and establishing two levels of transportation credits. One going into San Diego and Riverside and a lower -- the high current rate going into Orange, Ventura, and Los Angeles.

DR. SCHIEK: Establishing a higher credit rate in Riverside, San Diego, lower credit rate in -- is that right?

AGRICULTURE ECONOMIST GOSSARD: They would increase -- they would increase the credit going from Tulare into Orange, Los Angeles and Ventura, 1; and, 2, they would make Riverside and San Diego have a different rate higher than that. Do you support both -- the Institute supports both proposals?

DR. SCHIEK: Yes, we do.

AGRICULTURE ECONOMIST GOSSARD: In that paragraph, you mention shortfalls in credit should only be employed for the most distant milk, Fresno, and not the milk from relatively closer areas, Kern, Tulare, and Kings. But actually for credits there is no --

DR. SCHIEK: Yeah. That was -- maybe I was confused, but I was writing down how I was thinking, and I was writing about allowances. But the idea here is that, you know, the Fresno milk should have a small shortfall. But we're arguing that milk is going to have to flow from Tulare in a plant-to-plant basis and we would have full compensation on at that point.

AGRICULTURE ECONOMIST GOSSARD: Don't worry. I have been fooled by this whole subject at times.

Finally, on page 7 at the top, about the 5th line down, "In the case of tailored milk moving plant to plant, the tailoring is a service for which the buyer pays extra money through a service charge levied by the supplier."

If the transportation credit is too large, does that just end up meaning that the service charge is too small, doesn't reflect the total cost because the credit is making up the difference? How do we know when the credit is the right level?

DR. SCHIEK: Yeah, you could certainly set a credit level too high. But our point is that if the credit level is only covering the cost of moving the milk less the area differential, then its's only -- credit level is only pertaining to the transportation component, not the cost of the service of tailoring.

Does that make sense? Does that answer your question, I guess?

AGRICULTURE ECONOMIST GOSSARD: I would have to think about that for a second. But we may just pass, unless somebody else has a question. Otherwise I'm done.

DAIRY MARKETING BRANCH CHIEF IKARI: I just have a couple of just quick questions.

When you talked about the elongated process for the hearing, could you -- if you're going to file a post-hearing brief, could you identify the information that you would like the Department to prepare and announce that -- that would be --

DR. SCHIEK: Okay.

DAIRY MARKETING BRANCH CHIEF IKARI: The second question, turning back to that previous discussion about the allowance. The minimum allowance that the pool plan currently provides is nine cents. What if the Department provided minimum allowance of nine cents up to 59 miles in southern California; did you position stay the same?

DR. SCHIEK: You know, I think our overall position is that if there's a justification for giving an allowance, and if you want to say in order to ensure that -- if you wanted to say that --

DAIRY MARKETING BRANCH CHIEF IKARI: The closest milk goes?

DR. SCHIEK: Well, not so much closest milk. But that those who serve the market are rewarded. And it costs more for Dairymen to ship to a fluid plant than to ship to a local plant to one if they're given allowance that would equal that for equity basis. You know, we don't think that's the purpose of the allowance system. But if you were to do that, a key issue would be that you not sort of short change the more distant milk, because we do not believe giving that allowance because of the structure of the market down there will result in more efficient type communities. It would essentially be pool -- giving -- the pool would be paying money for some producers. But no sort of net result -- additional result other than transfer of income type issues would be achieved. No change and no procurement would be noted because of that. That's our opinion, our belief based on structure of the market.

MILK POOLING BRANCH CHIEF LEE: Brief question.

Dr. Schiek, in your testimony you mentioned that there's -- you do not have a position on premium skim receiving transportation credit. In your post-hearing brief could you -- would you have enough time for you to have a position --

DR. SCHIEK: Well, We have a position on that to oppose it at this time. Do we have enough time to complete the analysis? I can guaranty you we wouldn't. In a post-hearing brief is no.

MILK POOLING BRANCH CHIEF LEE: Okay. Thank you.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: And final question from myself.

You indicate that it makes sense to have a transportation allowance for milk so long as the contribution to the pool for that milk was greater than the cost of the allowance. What would you measure that -- or how would measure that contribution?

DR. SCHIEK: Yeah, a that's a good point. What I was thinking was that if you're not -- okay. If you're not sending that milk for the higher valued use, you're going to be sending it most likely to a 4A plant. We're talking about 2 and 3.

And so the point here was if it cost the pool 50 cents to ship that milk to the higher use plant, and the differential Class 3, for example, over a class 4A is 62 cents, I think there's still benefit in moving that milk to a higher value use.

AGRICULTURE ECONOMIST GOSSARD: Just to follow up my on early question on the service charge. It gets back to this whole issue of under the LOL proposal, what users will -- what comes out of pool to pay for an equivalent amount of milk moving ranch to plant versus plant to plant would be quite different.

Somehow shouldn't that difference be made up in the service charge the plant receiving the plant help is getting?

DR. SCHIEK: I guess I would -- no. I guess my feeling is that that's not necessarily the case. Because the service charge really pertains to the plant's cost of making the tailored milk the value added cost.

Now, if the plant were able to get that amount of service charge from the supplier -- you know, I'm sure they'd had like to. But I'm not sure that I would say that's a law or a bonafide principle that that service charge to equal that difference efficiency.

But, you know, what. I will give that some more attention in the post-hearing brief, if you'd like.

AGRICULTURE ECONOMIST GOSSARD: If you would please. It is obviously something that is of great interest to me.

No more questions.

HEARING OFFICER ESTES: Is the panel concluded?

Okay. Thank you for your testimony today.

And our next witness is --

THE REPORTER: Can we take a break for a minute?

HEARING OFFICER ESTES: Sure.

THE REPORTER: Okay. Thanks.

(Thereupon a lunch break was taken.)

AFTERNOON SESSION

HEARING OFFICER ESTES: Okay. We're back in session.

Before we proceed to take our next witness I just want to note that there's a correction to be made in terms of where to send a post-hearing brief. We will get them eventually if they come via the address, but basically you need to send them to 560 J Street, Suite 150, instead of 1220 N street, Room A224. So --

MR. VANDEN HEUVEL: We can still fax them, can't we?

HEARING OFFICER ESTES: Yes.

MR. VANDEN HEUVEL: And E-mail?

HEARING OFFICER ESTES: Yes.

So we'll proceed on with our next witness here today.

Gary Korsmeier, California Dairies, Incorporated.

Mr. Korsmeier, could you please state your name and spell your last name for the record.

MR. KORSMEIER: Yes, Mr. Hearing Officer. My name is Gary Korsmeier, last name is spelled K-o-r-s-m-e-i-e-r.

HEARING OFFICER ESTES: And could you identify the organization that you represent.

MR. KORSMEIER: I represent California Dairies.

HEARING OFFICER ESTES: And describe the nature of your organization and the process by which your testimony was developed for presentation today.

MR. KORSMEIER: And we have that in the first part of my testimony. Can I go ahead --

HEARING OFFICER ESTES: That would be fine.

MR. KORSMEIER: Fine. Thank you.

HEARING OFFICER ESTES: Let me just ask you one other question before you commence your testimony. I assume you want to introduce your written statement in the record as an exhibit?

MR. KORSMEIER: Yes, sir.

HEARING OFFICER ESTES: I'll introduce that in the record as Exhibit Number 67.

(Thereupon the above-referenced document was marked the hearing officer as Exhibit 67.)

(Thereupon the witness was sworn, by the hearing officer, to tell the truth and nothing but the truth.)

MR. KORSMEIER: Yes, sir.

Mr. Hearing Officer and members of the panel: My name is Gary Korsmeier. I'm President and Chief Executive Officer of California Dairies, Inc., headquartered in Artesia, California. We represent over 40 percent of the milk production in California, from approximately 700 producers throughout the state.

Our testimony today has been approved by our Board of Directors at their meeting held on May 28, 2003.

The majority of our testimony will address transportation allowances and credits in southern California where we have been the major supplier of milk for over 30 years and still represent over 50 percent of the milk produced in the southern California region.

The reasons for a transportation system to subsidize movement into southern California are evermore parent today because of the continual decrease in local milk production. In the past year, we have experienced almost a 10 percent decline in our southern California production and expect to lose an additional 15 percent in the next 12 months. More and more milk will have to be transported from Tulare and especially Kern Counties to satisfy the demands of processors in southern California.

A few notable exceptions prohibits us from supporting the petitioner, Land O' Lakes total proposal at this hearing today. But there's a lot more agreement than there is disagreement.

We are opposed to the alternate proposal by Milk Producers Council because each marketing area has its own unique set of transportation an marketing issues, and our viewpoint is similar to our testimony at the June 28, 2001, hearing on this same subject, that you cannot take a template and superimpose it over the marketing areas of this state and accomplish the objectives of milk movement provisions.

One of the provisions of the alternate proposal by MPC that is especially troubling to us is the changes to Section 921 of the pooling plan which would eliminate our cooperative's Artesia plant to receive transportation allowances. We have invested hundreds of thousands of dollars to equip that plant to handle the fluctuating needs of processors in southern California and provide condensed skim and pre-mixes to the market. Numerous times each week milk we have already scheduled from Kern County to Los Angeles has to be diverted to Artesia because of scheduling changes due to producer pickup times, processor delivery times, traffic congestion, or cancellation of orders. The Artesia plant has historically been and continues to be the balancing plant for southern California. And as long as we have more than 50 percent plant utilization in Class 1, 2, or 3, we should qualify for transportation allowances.

We would like to add more to that, if I could, at this time. When you look at the concern that some have expressed here today as far as the costs to the pool of bringing milk into this plant, because I believe this is the only plant that's really being singled out as far as the Milk Producer Council's testimony, we bring a lot more, tremendous more milk into that plant from local supply that does not get a transportation allowance than we do when bringing milk down from Kern County into that plant.

So, again, we believe that because of a higher utilization at least if it's over the 50 percent threshold that can Class 1, 2 and 3, that that plant needs to qualify because of the service that it provides.

The marketing conditions that we have today in milk movement are quite different than what we had at the last time we had this hearing in 2001. We have the issue of out-of-state milk, both in bulk and package form, and we've also got issues as far as going forward on how we're going to address this. And the market's going to change even more in the next several months.

So I think our industry needs to look at this situation. We need to possibly address something, maybe not that dissimilar to what Milk Producers Council is proposing that we have some kind of categories that we look at, because we've got different receiving areas in the state that are getting transportation allowances at zero miles. And I myself am questioning whether that need continues to be. So I do think there is a desire on our part at least to look at this and possibly look at some changes because of the marketing conditions that we now are experiencing.

We will now address our recommendations to both transportation allowances and credits.

Transportation allowances. We support the changes as proposed by the petitioner Land O' Lakes for southern California. The changes in designated supply counties that are able to receive transportation allowances and the rate change for the local southern California counties will reduce the overall cost of transportation allowances to the producer pool, not jeopardize the availability of milk to processors, and improve equity among producers in different regions of the state.

Prior to the changes made in September 2001, there was a provision that allowed for a 30 cent transportation allowance from all other counties into southern California, but with the addition of Santa Barbara as a designated supply county that covers the historical movement of milk into the Los Angeles areas. In our opinion, the necessary milk movement from ranch to plant for southern California is adequately a covered by the petitioner's proposal.

The petitioner did not address northern California transportation allowances, and we would like to recommend one change as follows: In Section 921.2(a), for plants located in the Bay Area receiving area, which shall consist of the counties of Alameda, Contra Costa, Santa Clara, Santa Cruz, San Francisco, and San Mateo, From zero to 99 miles we are requesting an increase to 28 cents from the current 24 cents; over 99 through 199 is 32 cents; and over 199 is 34.

Now, we've heard previous testimony or concern or question over the Bay Area movement. We are addressing this based on our historical movement in that area. And there might be, you know, many others here that will testify or other data that will be available that will indicate that, you know, this increase is not warranted based on the actual milk that's moving.

But as I move on to my testimony, we move our Marin County producers from time to time to the Bay Area at a cost of just under 60 cents a hundredweight. And even with the above 4 cent per weight adjustment for each of those categories, it still leaves our net cost of over 30 cents per hundredweight, which is at the high end of producer cost moving into the Class 1 markets in deficit areas. Again, thanking southern California.

The issue of transportation credits. Pursuant to

Section 300.2 of the Stabilization and Marketing Plan for market milk, we would like to recommend the following changes: As far as the designated supply counties, as far as Los Angeles County, the maximum deduction per hundredweight we are requesting a 10 cent increase that's presently at 24. I was a little bit disappointed that the petitioner did not address the Los Angeles County issue as far as transportation credit when he did address Tulare and Fresno.

And those from designated deficit counties of San Diego, Riverside, Orange, and Ventura, we are supporting to an extent this request in the Tulare County to move to Riverside or San Diego; and also from Tulare County to Orange, Los Angeles, and Ventura.

The latter category there of 60 cent is a 10 cent increase. And we're also -- if you notice, that's the same amount that we have suggested the increase in L.A. County so we keep the same competitive position that was established at the last hearing as far as L.A. County's movement into Riverside primarily would be the one plant that that would move into.

And the other one that's got quite a bit of attention I think we've got some maybe direct knowledge on, on Fresno and Kings County, we are recommending to delete that county in total as far as transportation credits are concerned. We are not aware of any movement out of those two counties over the last, you know, several years. Currently nothing is moving. And I don't envision anything would move from those counties. It's going to move from Kern and Tulare County, not Fresno or Kings. So we believe that we can delete those as far as receiving credits, as we've done with the allowances.

And then there's no change in the other areas as far as the other areas of the state.

We support the petitioner's request to separate Riverside and San Diego Counties with a higher deduction from Tulare County, but do not support the level that they are requesting. Disincentives from distant designated supply counties are still needed to allow for opportunities for local manufacturers to supply needed markets at a cost savings to the pool.

Therefore, we are recommending a 6 cent per hundredweight shortfall from the petitioner's proposal and have made a corresponding adjustment, as just stated, to the Los Angeles County designated supply rate to maintain the same relationship to our recommended Tulare County rate.

So those previous rates that I've quoted of 60 and 68 are a 6 cent shortfall from the petitioner's request.

A similar shortfall exists in Los Angeles County as evidenced by our testimony on June 28, 2001, which we stated that independent hauling rate quote of 39 cents per hundredweight has been -- we've received from moving, for deliveries to Riverside County from the Los Angeles County. And that's basically a two-year-old rate. And if we're using the 34 cents as we are recommending for L.A. County, that is very close to the 6 cents that we're recommending shortfall in the other counties.

Since there has been no plant to plant movement in the past few years from Fresno County to Los Angeles and there's absolutely no need to burden the pool revenues with unnecessary milk movement, we are recommending again that the Fresno and Kings County be removed as designated supply counties for transportation credits.

Our strongest objection to the petitioner's request is the inclusion of condensed skim as being able to receive transportation credits. As we stated earlier, our local southern California plant in Artesia is totally equipped to supply any and all condensed skim needs and has historically provided a high quality product, excellent service to the market at competitive prices. Market requirements have been more than adequately satisfied, and we are committed to supplying those markets in the future without a cost to the producer pool.

We appreciate the opportunity to testify on this important subject matter to CDI and recognize that some of our recommendations were not offered as an alternative proposal. But we feel our changes are not substantive and are fully supported by current movement and trends and actual costs.

And If I may, I'd like to add a couple items before questions.

One is to support the -- under questions and answers from Mr. Jeff Vanden Heuvel concerning RQAs in Mr. Bob Horton's letter. We do not believe RQAs should be addressed at this hearing at this time. That is a redistribution of producer dollars. And that should be something that should be addressed individually by producers and not at this hearing.

The petitioner's comments about having to make adjustments in condensed to be more competitive without a state. I think under the questions and answers that was also brought out, that that adjustment that he's asking for will not make him competitive or LOL competitive without a state condensed. None of us right now are competitive without a state condensed. And that change will not accomplish, you know, that request.

The comment was also made by the petitioner of the profits that he is currently obtaining from moving milk out of Kern County into Los Angeles as far as transportation allowance is concerned. I think we probably move more milk than anybody from that county into southern California, and there is not a profit moving from that county. It costs us about 65 cents. And you've got the 43 cent allowance. That's about 22 cents, which is pretty close -- very comparable to in-haul rates, you know, in that area and also in the Tulare area.

So we -- we are supportive of continuing the 43 and the 58 cents.

I think the other statement I need to make concerning movement into southern California in the future, as we continue to see the decreasing levels of production in southern California, Kern county is really going to be the county that is going to be needed for movement into southern California under the transportation allowance system.

The 43 cents, as I stated, is adequate to cover those costs today. And I think you'll see a enhancement of that movement from that county into southern California in for all actual purposes you really only need that county to move milk into southern California. You don't need milk from ranch to plant out of Tulare County. The 58 cents does not cover our costs in moving milk from ranch to plant out of Tulare County. But when you look at the volumes that are in Kern County, I believe that county itself can more than satisfy the desires of as far as processors in southern California at least moving from ranch to plant.

The plant-to-plant issue is Tulare. There isn't any movement currently from plant to plant other than Tulare or south of Tulare. But, you know, you could build a case that, you know, the movements that should occur in the future, that the 43 cent level would be the only level that would be needed. And you probably wouldn't even need the 58 cent level.

But we are at this hearing testifying in support of maintaining both of those levels at this time. And we would hope that -- I think Dairy Institute and others have stated that there could be some industry input or some industry involvement in looking at this whole issue of transportation allowances and credits, because as we move forward the changes are evident today that we're going to have to make some adjustments. And, again, when you look at some of the areas like receiving areas of Solano and the Bay Area, Sacramento, I even am somewhat questioning, you know, the need to have transportation allowances at the zero level.

One of the -- again, the proposal by Milk Producers Council was to in all areas. But I think maybe we can look at that in the future. And I'm not sure there is a need for milk that's, say, less than 25 miles to the market to have the transportation allowances in any of the receiving areas, because I think conditions have changed from the time when those were originally put in place. Now, that's my personal opinion, and I know that we would need to have a lot of industry input. But I believe that -- I am in agreement with the concept what Milk Producers Council was saying, but, you know, maybe we can look at changes in that to make it similar within the receiving areas that -- but not at the level of zero to 15 miles of a nickel and, you know, not in the aggregate or the amount that they stated.

So, again, I think that's concludes my testimony, Mr. Hearing Officer. And I'd be glad to answer any questions. And certainly we want the right to file a post-hearing brief.

HEARING OFFICER ESTES: Certainly.

Let me just mention about the post-hearing brief again for people that were late arriving.

And I have to say I'm a little confused about this myself just based on how we receive mail at the legal office. But there's been a big movement at different branches and divisions and things of that nature. Food and Ag has a major building renovation going on, which I'm sure many of you are already aware.

DAIRY MARKETING BRANCH CHIEF IKARI: If they mail it --

HEARING OFFICER ESTES: Yeah, if it's to be mailed --

DAIRY MARKETING BRANCH CHIEF IKARI: If it's mailed, it's to 1220 N street. But if they bring it into the office, then we want them to bring it to the J street address.

HEARING OFFICER ESTES: Did everyone hear that.

Let me just repeat it again. If you're going to personally deliver it, it should be delivered to 560 J Street, Suite 150. And if it's mailed, you can mail it to the old address, which is 1220 N street, I believe Room A221.

DAIRY MARKETING BRANCH CHIEF IKARI: No, just Department of Food and Ag at 1220 N.

HEARING OFFICER ESTES: And then of course you can FAX them, as has always been the case, or E-mail them as well, which might be the most efficient way of doing it.

So does the panel have any questions?

SENIOR AGRICULTURAL ECONOMIST ERBA: I have a couple questions of Mr. Korsmeier.

You said initially were you opposed to Milk

Producers Council's proposal because of the template, you didn't want to be able to superimpose it over marketing areas that have different characteristics and so forth.

What about some of the other concepts being advanced, like prorating the transportation allowance based on Class 1 usage, or on the concept of any Class 1 plant should qualify for some kind of allowance? Now, you may have to do some tinkering to get around the issues that you've brought up. But you could possibly take each one of those markets that deal with it one on one to get around the issue you brought up. Are you opposed to the other concepts as well?

MR. KORSMEIER: Yes, I think at -- at this juncture we believe that the current qualifying for plants of the 80 percent Class 1 is adequately satisfying the market needs and we would be -- so we would be not supportive of their position of class 1 only.

SENIOR AGRICULTURAL ECONOMIST ERBA: And what about any Class 1 plant no matter where it's located not to qualify for the allowance?

MR. KORSMEIER: No, we're -- again, we're opposed to that portion of the request also.

SENIOR AGRICULTURAL ECONOMIST ERBA: Do you have some proposals -- I guess a proposal to change the rates into the Bay Area and which would increase them about 4 cents per hundredweight? Do you have any evidence that you can submit to that?

MR. KORSMEIER: Yes, I do. And we have a letter from the company that hauls that milk that I will put in my post-hearing brief.

SENIOR AGRICULTURAL ECONOMIST ERBA: That would be terrific.

Also on the -- and I'm on page 3, the same page you have proposed increases for the transpiration credits for Los Angeles County and for -- just for Los Angeles County is what I'm interested in -- up from 24 cents to 34 cents. But you decrease -- you take out the Fresno and Kings Counties because there's been no movement of milk out of those counties by using a transportation credit system.

To your knowledge has the transpiration credit in L.A. County been used --

MR. KORSMEIER: No, it has not. So along that line of reasoning you would say why would we want L.A. at all. That was put in in 2001 to give us the opportunity to provide that at some future date. And I think that possibility is still a very strong possibility; where the Fresno-Kings, that it's very remote, and I don't believe it could be used at all.

SENIOR AGRICULTURAL ECONOMIST ERBA: So it's more along the lines that you feel like it gives you an opportunity to do something, even though you may not be doing it now --

MR. KORSMEIER: That's correct, we are not doing it today.

SENIOR AGRICULTURAL ECONOMIST ERBA: That's all the questions I have.

MILK POOLING BRANCH CHIEF LEE: Regarding the statement about the decline in milk production in southern California and another one in, next to -- could you describe to us this change, what's causing this change?

MR. KORSMEIER: I think what we're seeing in the greater Chino Valley area right now is the movement that a lot of us projected was maybe going to happen ten years ago. The real estate values are quite strong, and we're seeing a number of escrows being closed and areas actually relocating. Some of them are going out of state. However, the majority of the milk that we're losing in the next year, the 15 percent, the majority of that milk is going to Kern County and more than likely will be part of our supply to the southern California marketplace. So it will stay within the state. It will stay within the area that I believe should serve southern California.

MILK POOLING BRANCH CHIEF LEE: Thank you.

DAIRY MARKETING BRANCH CHIEF IKARI: Mr.

Korsmeier, would you be opposed to a transportation allowance in southern California greater than zero but less than 89 miles?

MR. KORSMEIER: Our current position is that we are not supportive of including southern California in the transportation allowance system. And, Mr. Ikari, part of that is a factor of looking at producer equity amongst the state, and that is also -- and, therefore, that automatically brings in the issue of RQAs.

Our southern California producers are approximately 50 percent quota. I think the number I heard earlier was 47 percent of southern California market place was quota. And when you look at the comparison of Tulare County to southern California where they have a 27 cent negative RQA. And if you've got about a 50 percent quota in southern California, you've got a 12 or 13 cent amount there that the southern California producers have that the Tulare County producers do not. And so we are not supportive of transportation allowance to southern California right now because we believe the RQAs help equalize that factor.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

AGRICULTURE ECONOMIST GOSSARD: You have mentioned your opposition to the Milk Producers Council proposal that it would only apply to Class 1 milk.

Under questioning they said as an alternative they might be comfortable with the performance requirement, currently 50 percent, 1, 2, 3 utilization were raised.

How would you feel about that?

MR. KORSMEIER: We would be in opposition to that. And there's solid reason that -- behind that is that that -- the Artesia plant's total utilization is close to that number. And any reduction of that number would automatically disqualify that plant.

AGRICULTURE ECONOMIST GOSSARD: You had stated that you support the concept of Land O' Lakes limiting the counties that can get transportation allowance shipping milk into southern California. You even suggested that you might be able to limit it to just Kern County. But in your proposal to make the changes in the allowances to northern California, you don't make any proposal to limit which counties can deliver that milk. So under the LOL proposal, which you supported, producers shipping from Modesto to southern California would not get an allowance, but a producer shipping from Riverside to the Bay Area would. Would that be consistent?

MR. KORSMEIER: Well, without question that is inconsistent. Our present recommendation is inconsistent as it relates to southern California as to the Bay Area.

We do not have the detailed knowledge of the milk movement in northern California certainly to the extent that I have in southern California.

When you look back at the hearing, prior to this prior hearing where the changes were made, that's really the adjustments we're asking for, is to go back to where we were before the last hearing. But without question, it is not consistent. And I guess my answer to that would be is that there's different factors and conditions within those market places that create that difference, but that was to be something that we would be very willing to look at because of I think going in the future that that inconsistency needs to be addressed.

AGRICULTURE ECONOMIST GOSSARD: In your proposal on the shortfall into the Bay Area, instead of citing an individual local haul applicable to any one area, you said that 30 cents per hundredweight should be representative of local hauls in general. Would you apply that across the whole state?

MR. KORSMEIER: Well, I was implying it to the -- the answer would be no because I don't have the acknowledge to apply it in all of the factors that are involved in some of the other areas of the state.

I used the 30 cents in comparison to the southern California rates, that are in the low 30 cents from the

Chino area into southern California. And they do not get, you know, the transportation allowance from that movement. So I made that consistent with the 30 cents with that movement.

AGRICULTURE ECONOMIST GOSSARD: Okay. Under your proposal there'd be a -- of transportation credits there would be a 6 cent shortfall for milk coming from Tulare either to Riverside or to L.A., but a 5 cent shortfall for milk coming from L.A. into, say, Riverside.

Would it be more consistent to make it 5 cents across the Board -- or 6 cents across the Board or 5 cents?

MR. KORSMEIER: Well, Mr. Gossard, what I didn't do is I didn't get an updated number as far as the costs from Los Angeles County to Riverside. But I guess I presumed very comfortably that in a two-year timeframe that that cost would have gone up at least a cent if not more. So I did feel that there was some consistency there.

AGRICULTURE ECONOMIST GOSSARD: Okay. You mentioned that you are not competitive with other source milk -- condensed skim as coming in as other source milk.

Why aren't we competitive and what could we do about it.

MR. KORSMEIER: I think that was brought out in the testimony of the petitioner under the examination or questions and answers, that from our calculations the condensed coming in from the Nevada area into southern California, that the federal order -- impact of federal order handling of that condensed does not make us competitive. And I think under possibly your question that you had to Dr. Gruebele is that's something that should be looked at. And we would be definitely supportive of that.

AGRICULTURE ECONOMIST GOSSARD: You state it's your belief that Kern County alone has enough milk to make up the deficit in southern California. The evidence on the record, including MPC's testimony of the milk production in Kern County, would indicate there would still be a shortfall. Would that be an indicator that you need to have allowances for more than just Kern County?

MR. KORSMEIER: I think, Mr. Gossard, if we, and we most likely will, within a year or a year and a half have another hearing on this subject, I'd be able to definitely answer that question because we do expect a million or a million and a half more pounds of milk in Kern County in the next 12 months.

AGRICULTURE ECONOMIST GOSSARD: And how much are you going to lose in Southern California?

MR. KORSMEIER: We will lose a comparable amount

in southern California.
AGRICULTURE ECONOMIST GOSSARD: Okay.
MR. KORSMEIER: But Kern County would still be, when you look at the production from that county -- I'm not aware of any consistent movement from Tulare County into the southern California milk shed. I believe that -- that was the case here several months ago, and I believe the petitioner was the one that was doing that. I don't believe that movement is continuing because the economics really aren't favorable to do that. And we still believe there's no reason why that should continue, or we should encourage it to continue.
AGRICULTURE ECONOMIST GOSSARD: Now, in Department -- here in Exhibit Number 7L, the individual counties moving into southern California are listed. And it shows Tulare County as of March 2003 moving two million pounds of milk into southern California as opposed to Kern at 2.3.
Has something changed dramatically since March 2003?
MR. KORSMEIER: No, they have not. I just didn't have that knowledge. Actually the changes I'm referring to happened in February, not March.
AGRICULTURE ECONOMIST GOSSARD: No further questions.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: Mr. Korsmeier, on page 4 on the paragraph where you raise your strongest objection and, that is, to petitioner's request to include condensed skim as being able to receive transportation credits. The last sentence in that paragraph reads, "Market requirements have been more than adequately satisfied and we are committed to supplying these markets in the future without a cost to the producer pool."

Doesn't some of that milk going into your plant receive transportation allowance?

MR. KORSMEIER: Yes, it does.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE:

And isn't that a cost to the pool?

MR. KORSMEIER: At that level. But as I indicated earlier, it is a very low percentage of the actual total milk that that plant does receive. But, yes, so that would -- that particular portion would be, quote, a cost to the pool.

HEARING OFFICER ESTES: Thank you for your testimony today.

MR. KORSMEIER: Thank you.

Let's see, our next witness is Stephen James.

Mr. James, would you please state your name and spell your last name for the record.

MR. JAMES: It's Stephen James with a p-h. And the last name is J-a-m-e-s.

(Thereupon the witness was sworn, by the
hearing officer to tell the truth, and
nothing but the truth.)

MR. JAMES: I do.

HEARING OFFICER ESTES: Would you identify the organization you represent and the process by which your testimony was developed today.

MR. JAMES: I am the President and General Manager of Swiss Dairy in Riverside, California. And my testimony was developed by myself and other members of my corporation at large.

HEARING OFFICER ESTES: Would you like your written statement be entered into the record today?

MR. JAMES: Yes, please.

HEARING OFFICER ESTES: It will be introduced as Exhibit Number 68.

(Thereupon the above-referenced document
was marked by the hearing officer as
Exhibit 68.)

HEARING OFFICER ESTES: Please proceed with your testimony.

MR. JAMES: Thank you.

Mr. Hearing Officer and members of the hearing panel, my name is Steve James. I'm President of Swiss Dairy located in Riverside, California, and I'm testifying on behalf of my company. Swiss Dairy is owned by Dean Foods based in Dallas, Texas. In addition to Swiss Dairy, Dean Foods operates plants in the City of Industry, Buena Park, Fullerton, Gustine, South Gate, San Leandro, Hayward, and Tulare, California. Dean also owns and operates Model Dairy located in Reno, Nevada. Swiss Dairy is a fluid bottling plant.

Swiss Dairy supports the position presented by the Dairy Institute of California. Our company is facing substantial challenges in the months ahead. As members of the hearing panel are aware, a new large fluid milk bottling plant has been recently built in Yuma, Arizona. The new plant has an aggressive marketing plan and is seeking to supplant California-based bottling plants as suppliers to key retail fluid milk outlets in California. Under current law, the new plant is not regulated and, as such, will have a tremendous raw product cost advantage over plants in California, which must pay regulated minimum Class 1 prices. In this environment, it is crucial for us to be able to attract milk to our plant without having to subsidize such procurements if we're to continue to be a viable Class 1 outlet for producer milk.

We agree with the Dairy Institute's assertion that milk should be made available to Class 1 plants at order prices. Prior to pooling, Class 1 plants did not have any problem attracting milk because the higher regulated price they paid went directly to dairymen and provided a strong incentive to ship to the Class 1 market. When pooling was adopted, dairymen and their cooperatives no longer had a direct incentive to supply Class 1 markets on the basis of regulated minimum class prices. In the new environment, producers would choose to ship their milk to the plant that resulted in the shortest or lowest cost haul regardless of which products the plant made or the size of the contribution the plant made to the pool.

Milk should move to Class 1 plants at order prices without the requirement that buyers subsidize the hauling rate, by virtue of the fact that the Class 1 plants contribute more money to the pool and enhance prices to producers.

When transportation allowances and credits are not adequate to move milk to deficit areas, the milk supplier is faced with the choice of either subsidizing the added hauling cost themselves or passing the cost on to his consumer -- on to his customer. If the customer has other supply options that are available, he or she will exercise those options provided the milk is available at a more competitive price.

In the past when credits and allowances were not sufficient to attract milk from the South Valley, a reasonable assumption would be that such a shortfall would encourage buyers to procure milk from more nearby locations, resulting in more efficient milk movements. We recognize the attractiveness of this argument in theory. However, in the southern California market theory comes face to face with reality. The existence of a large cheese plant in the middle of the southern California supply area means that not all of the milk in the area is available to Class 1 plants. Therefore, milk must come from the South Valley to keep the market adequately supplied. If the South Valley milk is not available at order prices, buyers will look to other sources. If local supply is likewise not available, milk supplies outside the state are an option. Some Class 1 processors have elected to receive their Class 1 supplies from outside the state.

It's important that transportation allowances and credits are set at rates that are cost justified and adequate to draw milk to deficit areas so that the local Class 1 market is secured for California producers. The notion of encouraging efficient milk movements through shortfalls in the allowance rates is a laudable one, but the Department must consider the current structure of the market in setting the rates. Because much of the local milk supply is not available, milk supplies from the South Valley are necessary for the Class 1 plants in southern California. Therefore, transportation allowances and credits should be set without a shortfall for all but the most distant supplies. Current transportation credit rates are not adequate to ensure that the Class 1 market is served.

The transportation credit rates proposed by Land O' Lakes reflect the cost of moving milk plant to plant into southern California plants less the area differential and it should be adopted. Unless the combination of the area differential and transportation credit covers freight costs, plants like ours face unequal raw product costs and make us noncompetitive in the sale of our Class 1 products.

The current system does not do that. The haul rate from Tulare to Riverside is currently $1.01 per hundredweight and the transportation credit's only $.50, while the area differential is only $.27 per hundredweight. We cannot compete with a 24-cent per hundredweight shortfall. A small shortfall is appropriate for the most distant milk and should be applied to the proposed credit rates from Fresno only.

While transportation credits for condensed skim may have some merit given the necessity of condensed skim for fortification to the California standards, we agree with Dairy Institute that the impacts of such a change need to be examined more fully by the industry before it's adopted.

We believe that there is a difference between the incentive necessary to move milk ranch to plant and the incentive necessary to move milk plant to plant. The key question that must be answered in setting credit rates relates to the incentive necessary to get milk to move to southern California plants. In the case of allowances, the incentive needed is equal to the difference between the local haul and the long haul to the plant in a deficit area. In the case of credits, the incentive is the cost of hauling milk plant to plant less any area differential. We do not see the necessity of adjusting the rates of credits and allowances so that they are more or less equal for a given type of milk. The rates should be set so there is an adequate incentive for the milk to move.

Some have suggested that plant-to-plant milk movements are not needed because there are adequate supplies of milk that are closer to southern California, in Kern County, for example, that could supply milk by ranch-to-plant shipments. However there is a need for plant-to-plant milk movements. Moving milk by a ranch to plant exclusively would result in more butterfat at Class 1 plants than is needed. Some plants may have customers who will take the cream or have other processing operations that will utilize the cream. But for many plants the surplus cream creates a disposal problem. Significant costs are incurred to move the surplus up to manufacturing plants in the South Valley. Therefore, there's a need for plant-to-plant shipments of milk and skim in order to minimize back hauling of cream to the valley, and transportation credits associated with plant-to-plant movements of milk and skim into southern California must adequately compensate the supplier for the haul.

Comments have been made in past hearings, and this one, about the efficiency benefit plants such as ours receive by getting tailored milk under a transportation credit from our supplier. The Swiss plant is not capable of converting producer milk to meet California standards, and that's why we have contracted with Land O' Lakes to supply the standardized product on a plant-to-plant basis.

One important advantage of purchasing standardized milk is that it avoids the unnecessary movement of unneeded fat from Tulare to Riverside, California. Our supplier can use the fat in their manufacturing operation. And it makes little sense to move the unneeded fat in both directions.

For us to receive only producer milk would require a major capital investment. Before we do that, we would have to evaluate alternatives. This did not appear to be a problem until the Department decided not to adjust the transportation credit two years ago even though the evidence clearly showed the need to do so.

The Swiss plant pays Land O' Lakes a service charge to produce standardized milk. Our whole plant was designed to accommodate the fluid milk standards by purchasing standardized milk on a plant-to-plant basis from the South valley. Past policy decisions made all this possible. There were either the existence of an adequate area differential or a combination of an area differential plus an adequate transportation credit. The lack of any adjustment in the transportation credit two years ago placed us in a very difficult position from a competitive standpoint.

MPC's proposal would give allowances to milk that would move to fluid plants anyway without the availability of the allowances. Therefore, it takes money from the pool that is not needed to encourage milk to move to fluid plants. Milk movement provisions are concerned with encouraging the movement of milk to the higher use plants. They are not intended to equilibrate hauling costs among producers.

The availability of transportation allowance incentives on local milk in southern California as proposed by MPC, while perhaps seeming to provide an incentive to pull milk away from manufacturing plants and into fluid plants will result in little extra milk movement from southern California to fluid plants because the large cheese plant in southern California is a cooperative and will retain control over its members' milk. The cooperative is national and has the ability to move money from other areas in order to match any incentives that might be made available by transportation allowances to local producers shipping to qualified plants.

South Valley milk is necessary for the Class 1 processors in southern California to be adequately supplied. MPC's proposed allowance and credit rates are insufficient to encourage necessary milk movements. MPC's one-size-fits-all approach has not been supported in the past. Past hearing decisions have confirmed the uniqueness of different local markets and the differing rates on allowances and credits that are necessary to move milk. MPC's approach may be simpler, but it does not make economic sense given the purpose of the allowance and credit system to ensure that higher use plants are served.

The burden of proof should be on MPC to prove that their proposal would result in Class 1 markets being served in a more efficient manner, without causing Class 1 plants to have to subsidize the transportation of milk to their plants. Swiss Dairy urges the rejection of MPC's proposal for all the reasons we've mentioned.

And I would also request an option to file a post hearing-brief. And I thank the hearing panel for their time, and I'd be happy to answer questions.

HEARING OFFICER ESTES: Yes, you have the opportunity to file a post-hearing brief.

Are there any panel questions?

AGRICULTURE ECONOMIST GOSSARD: On the first page of your testimony, Mr. James, you mentioned that in the pre cooling pre-pooling days a Class 1 plant would not have any problem attracting milk. However, the industry's changed a little. When pooling when into effect 65 percent of the milk was Class 1. Now it's down to 19 percent.

Do you think these structural changes would change the picture if we did away with pooling and just had minimum pricing?

MR. JAMES: Well, I didn't think I would be asked such a wide ranging question about eliminating pooling. And not being an expert in pooling but being an expert in the veracity of the competitive marketplace, I would respectfully defer that to other minds with more experience in pooling.

AGRICULTURE ECONOMIST GOSSARD: My other question: You mentioned the situation regarding the Yuma plant. And you list the plants that you currently are operating, including one in Reno, Nevada. Is it not true that Dean's building a plant in Las Vegas, Nevada?

MR. JAMES: I believe there is one under construction as we speak, yes.

AGRICULTURE ECONOMIST GOSSARD: But you're not familiar with that plant in any detail?

MR. JAMES: No, I'm not.

AGRICULTURE ECONOMIST GOSSARD: Okay. No further questions.

HEARING OFFICER ESTES: Any of the panel have questions?

Thank you for your testimony today.

MR. JAMES: Thank you.

Our next witnesses are from Western United Dairymen.

Would each of you please state you name and spell your last name for the record.

MR. MARSH: Michael Marsh M-a-r-s-h.

MS. LaMENDOLA: Tiffany LaMendola

L-a-M-e-n-d-o-l-a.

(Thereupon the witnesses were sworn,
by the hearing officer, to tell the truth
and nothing but the truth.)

MS. LaMENDOLA: Yes.

MR. MARSH: Yes.

HEARING OFFICER ESTES: Could both of you -- could one of you describe your organization and the process by which your testimony was developed and approved here today?

MR. MARSH: Yes, that's including our testimony.

HEARING OFFICER ESTES: Okay. I assume you would like to have your written statement introduced into the record as an exhibit?

MR. MARSH: Yes, we would.

HEARING OFFICER ESTES: Okay. It will be introduced in the record as Exhibit Number 69.

(Thereupon the above-referenced document
was marked by the hearing officer as
Exhibit 69.)

HEARING OFFICER ESTES: And please proceed with your testimony.

MR. MARSH: Thank you.

Mr. Hearing Officer, members of the hearing panel. My name is Michael Marsh. I'm the Chief Executive

Officer of Western United Dairymen. I'm also a Certified Public Accountant licensed to practice in the State of California. With me today is Tiffany LaMendola, Director of Economic Analysis. An elected board of directors governs our policy. Our association is the largest dairy producer trade association in California, representing approximately 1100 of California's 2,000 dairy families. We are a grass-roots organization headquartered in Modesto, California.

An extensive process was used to arrive at the position we will present here today. Western United Dairymen starts the process with a committee of dairy leaders from around the state. They ship milk to all types of plants, and many effectively serve the industry on other boards. The committee conducts long and thoughtful discussions of all sides of the issue at hand. Committee recommendations are presented to the board of directors for review, modification and approval. The Committee, Dairy Programs Committee, met April 23rd, 2003, and the board of directors met May 16, 2003, to approve the position we will present here today.

Because data from the Department was unavailable for review by our committee and board prior to their meetings, our testimony today will generally be limited to broad policy recommendations. The board of directors would liked to have seen more industry dialogue, similar to workshops held before last hearing, before the call of this hearing so soon after the last changes were made. This would allow the industry an opportunity to review the impacts of the last changes to the transportation credits and allowances and allowed us to better ascertain where modifications might be necessary.

Now, in saying that I would also second the comments or -- also the comments made by Mr. Korsmeier and Dr. Schiek with regard to perhaps a little bit different process perhaps the next time we do a transportation allowances and credits and as we raised at the workshop the other day, just to a allow us a better opportunity to review the -- being compiled by staff and allow us to make a better decision as we bring this information back to our board of directors.

And I would like to also commend the staff for the information that was provided in the workshop. I think they did a great job.

Our committee and board both agree with and continue to support those guidelines set forth by the Department during the last hearing with respect to setting transportation and incentives. Producers who serve the Class 1 market ought to be rewarded. The closest milk to the market ought to move first. And a regulated system ought to attempt to minimize costs to the pool.

We strongly encourage the Department to stay committed to these basic tenets in their review of the proposals at hand and in their recommendations to the secretary.

Upon review of transportation incentives in preparation for this hearing our board of directors raised many serious concerns. It is apparent that there are flaws in the current movement system that need to be addressed. However, it is also apparent that there are no easy solutions.

Data provided by the Department confirms the fact that southern California has plenty of milk to fill its Class 1 needs. Yet producers pay millions of dollars to facilitate movement of more milk into the market.

On top of California milk moving to southern California, out-of-state milk is also flowing in at rapid rates, threatening the very stability of the California pool. Many reasons have been advanced as to why this is occurring. One common argument is the fact that a great deal of milk is attracted to the cheese plant in Corona, reducing the amount of milk available to fluid purposes. The inappropriate location of the cheese plant is not something we have any control over, yet it will greatly impact the effectiveness of our milk movement incentives as competition for milk makes it more costly to fill Class 1 needs. Furthermore, the cost of the transportation incentive program has grown to somewhere near $16 million per year, a cost far in excess of what anyone would like to see. These are just a few concerns. Issues like this are numerous. Though we do not pretend to know all the solutions to these problems, we will do our best to provide comments on aspects of the proposals at hand.

In addition to the basic tenets outlined above, our board was able to come to agreement that a common sense approach should be used in setting transportation allowances. That is, to the greatest extent possible, allowance should be based upon data from the Department. This is the most reliable data available to the industry as a whole. When using data gathered by the Department, consideration should also be given to recent developments such as the recent decline in diesel fuel prices.

We agree with the basic guiding principle that has historically been used: Through transportation allowances, shippers should be made indifferent when choosing to ship the milk locally or to the more distant, and presumably a higher usage, plant. We also agree with the Department that a shortfall should continue to exist in the structure of any area receiving a transportation allowance to encourage the closest milk to move first.

MS. LaMENDOLA: Regard to the Land O' lakes proposal, different mileage brackets and limited supply counties to southern California. The LOL proposal to limit supply counties and reduce allowances for certain counties supplying southern California seems to have two apparent goals:

First, to reduce the transportation allowance for producers located in San Bernardino County who, they argue, are receiving higher than necessary allowances.

And, second, to limit shipments of milk from the Central Valley into southern California that are currently covered by allowances.

Of particular concern to our board is the fact that some producers may be overcompensated for their hauling costs through transportation allowances. Under no circumstances should producers make money off transportation allowances. This is not the purpose of transportation allowances and necessarily increases costs to the pool. However, our concern is statewide rather than for any specific county. No matter where a producer is located, they should not make money off transportation allowances.

Though we will not comment on LOL's specific proposal to change mileage brackets and rates for certain counties, we urge the Department to review allowances and respective hauling rates in all areas of the state when making recommendations on changes to transportation allowances. If changes need to be made, we urge them to do so in order minimize costs to the pool.

LOL's southern California transportation allowance proposal is estimated to generate $276.6 thousand cost savings to the pool. According to the Department, most of these savings are due to the limitation in supply counties, not to the proposed rate structure. From the Department analysis, we can see that nearly one billion pounds of milk currently moving to southern California would no longer be eligible under the LOL proposal.

Of course our board would like to see the southern California market served primarily by closer-in milk. This makes sense. However, for some reason this is not occurring. Therefore, if milk is going to move from further distances, why should the counties be limited? If milk moves from Tulare County at a cost of 58 cents a hundredweight versus from Stanislaus County at a cost of 58 cents per hundredweight, there is no difference in total cost to the pool. Obviously if the milk would move from a closer location, there could potentially be cost savings involved. However, we have no way of knowing whether or not this will occur.

As CDFA pointed out in the last panel report: It, the panel, is not willing to exclude other counties from the available transportation rate. To do so discriminates against producers who may wish to ship milk into southern California based on strictly on the location of their dairies. Furthermore, designating eligible and ineligible counties may actually decrease the supply of milk available to Class 1 plants, a result which does not work toward the principles previously outlined by the panel.

Our board agrees. If milk must move to southern California from distant locations in order to serve the Class 1 market, all counties should be eligible.

LOL proposal in regard to extension of transportation allowances to Riverside County:

Our board supports the addition of Riverside County as a receiving area for transportation allowances in southern California. Apparently, two plants with high Class 1, 2, and 3 utilization are located in the county. Currently Riverside County is considered a deficit county and under transportation credits, thereby making plant-to-plant milk eligible to receive transportation credits. Our board sees no reason why ranch-to-plant milk should not qualify as well. Additionally, conversations with the Department indicate that most of the milk shipped to Riverside is local milk. This makes sense being that, according to the Department, there is more milk production than Class 1 processing in the county. Therefore, under the current rate structure, the addition of Riverside County as a receiving area will not significantly increase costs to the pool.

MPC proposal - only Class 1 milk covered by transportation allowances:

Though our board seriously considered this option, they concluded that transportation allowances should continue to cover shipments to plants with more than 50 percent Class 1, 2 and 3 utilization. Our board feels that Class 2 and 3 are also higher valued uses, and that eliminating them from coverage may have larger implications. Primarily their concern rested with milk procurement issues. Would eliminating some of these plants encourage them to turn to out-of-state sources as suppliers? Also, would eliminating Class 2 and 3 also end up impacting Class 1? These were questions that they had.

Data from the Department shows that there are 49 eligible plants with more than 50 percent Class 1,2, and 3 utilization. Only 30 of those are currently in designated receiving areas. Of those 30 all but one have a Class 1, 2, and 3 utilization of more than 90 percent. Therefore, there is very little Class 4A and 4B milk covered under the current system. This means most of the milk currently covered is all going to higher valued uses. Our board could find no reasons to change this at this time, but would be support of a deeper examination through an industry-wide meeting. This could possibly aid in addressing the concerns of our board of directors.

MPC proposal - statewide Class 1 transportation allowance:

Though we applaud MPC for attempting to make structural changes to the current milk movement incentive program, we do not support their proposal for a statewide Class 1 allowance. As the Department pointed out in their last panel report, northern and southern California represent two different marketing areas and there are distinct differences among plants in their ability to attract adequate milk. Also, there are differences in hauling costs across the state. A statewide rate disregards these differences.

Of primary concern is the fact that under the MPC proposal, transportation incentives would be provided to move Class 1 milk in areas where Class 1 is the only option. This is most obvious in areas such as Humboldt. In fact, ranch-to-plant shipments to ten new plants would be eligible under the MPC proposal, some of which do not need transportation incentives to attract milk. Though one of the basic tenets outlined by the Department is to reward producers who serve the Class 1 market, we contend that this means to reward producers who choose to ship to fluid purposes rather than to more local manufacturing plant. When fluid purposes are their only option, an incentive does not need to be made available. This simply increases the cost of transportation to the pool. As the Department concluded in the last hearing panel report when discussing a need for allowances in certain areas, "Ostensibly, there was no reason to offer incentives to producers to ship to fluid milk plants if that was the only practical option available."

Much of MPC's proposal centers on the concept of equity. That is, all Class 1 milk in California should be treated equally. However, we argue that we cannot sacrifice efficiency to gaining equity. Though a Department analysis shows a cost savings to the pool, most of these savings are due to changes in the rate structure alone. A statewide approach that handles northern and southern California similarly discounts critical differences that exist between the two areas and would therefore lead to inefficiency.

MPC proposal - southern California mileage brackets:

Upon review of MPC's proposal, our board felt that the addition of a closer-in bracket in southern California has merit. In reviewing the basic tenets, a closer-in bracket in southern California has the ability of accomplishing all three. Currently, nearly 89 percent of the cost of the transportation allowance system in southern California is contributed to milk moving over 125 miles, which is 35 percent of the milk. The 58 percent of the milk located within 74 miles receives no allowance. Obviously, we would like to see the southern California market served by producers in southern California rather than northern California, i.e., a reduction of the 35 percent of the milk traveling over 125 miles.

However, we have a few concerns with this aspect of the proposal. The first question we tried to answer is, will it make milk movement more efficient? That is, would the addition of a closer-in allowance actually provide an incentive for additional milk to move to fluid purposes from local southern California sources. If it did, this could potentially displace milk moving from further distances and possibly reduce costs to the pool. However, our board at this time was unable to find conclusive arguments to support this scenario.

Of major concern is the cheese plant located in Corona and its ability to attract milk over fluid plants. Will the cheese plant in Corona simply increase their premiums and continue to attract nearby milk into the plant? We realize that the cheese plant must stay competitive and, therefore, it must have some limit on their premiums. But we are unconvinced that the allowance proposed would be high enough to offset potential premium increases offered by the cheese plant. Therefore, we are not convinced that additional southern California milk would be attracted to fluid purposes with the closer-in bracket MPC is proposing.

Without sufficient justification, we assume this part of the MPC proposal may simply shift money from further out milk to closer in milk due to the change in the mileage brackets and rates and will not lead to increased efficiency of milk movements in southern California.

Moving on to transportation credits. We do not support an increase in transportation credits as proposed by LOL. According to Department analysis, at a minimum the LOL petition would increase the cost of the transportation credit system somewhere between 20 and 30 percent or $.94 to $1.41 million. The most recent departmental analysis shows an estimated increase of 28 percent or $1.3 million.

LOL has cited increased diesel costs as a reason to increase credits. However, since its peak of $1.83 per gallon the first of March diesel prices have fallen $.32 a gallon. The higher diesel prices are likely reflected in the March 2003 hauling rates compiled by the Department. This data may therefore misrepresent current and future hauling costs. We are aware that LOL reduced their requested increase to reflect lower rates. However, we are not supportive of the additional cost to the pool. There are no compelling arguments that suggest an increase in credits to southern California would lead to more efficient milk movement.

LOL's proposal would also eliminate any shortfall in the transportation credits to southern California. According to the Department, historically, "Transportation credits offset some of the cost of hauling milk assigned to Class 1 usage from plants in designated supply counties to plants in designated deficit counties." It is our understanding that it will also eliminate the current relationship between transportation allowances and credits from Tulare to southern California. According to material handed out at the pre-hearing workshop:

In 2001 based on this approach, the panel recommended, and the secretary implemented, an increase in the transportation allowances into southern California, but left the corresponding transportation credit unchanged. This resulted in an unprecedented level in the shortfall for the credit. However, the panel found that by doing otherwise, it would have favored plant-to-plant movement over ranch-to-plant. The Department's goal was to create a level playing field so that the comparative advantages of ranch-to plant vs plant-to-plant movement would determine which is used.

The LOL proposal disregards the Department's attempt to develop a level playing field. It also disregards the calculation of the credit established for Los Angeles County. Furthermore, the Department explains that currently, due to the assumption used to establish the credits and allowances in place, plant-to-plant movement is probably favored over ranch-to-plant from Tulare to southern California. According to Department analysis, the LOL petition would further increase the net pool credit for milk moved under transportation credits, thereby favoring plant-to-plant movements much more than ranch-to-plant with the equivalent amount of milk. This seems contrary to the basic tenets set forth by the Department.

MPC proposal on a statewide Class 1 credit on all Class 1 milk:

For much of the same reasons we do not support a statewide allowance. We also do not support a statewide transportation credit as proposed by MPC. Again, a statewide approach ignores the distinct differences between northern and southern California. Though Department analysis shows the cost of the pool would be lowered under the MPC proposal due to lower rate schedules for currently eligible plants, there are unknown costs associated with plants that would become eligible under the MPC proposal. These additional costs of the pool are absent any evidence that plant-to-plant milk movements would be more efficient. Of greatest concern is that producers will simply pick up added costs for milk that is already moving with no benefits returned.

Finally, LOL's proposal on transportation credits for condensed skim:

Furthermore, we do not support the addition of a transportation credit on condensed skim. Departmental analysis shows that for all of 2002 the addition of a credit on condensed skim would have increased cost to the pool by .41 million. Tailored milk shipped to southern California is already covered by transportation credits that return a higher net pool credit than shipping the equivalent amount of milk ranch to plant. We assume this tailored milk also demands a premium in the marketplace. There is no justification for producers to also cover the costs of hauling a manufactured product such as condensed skim to the southern California market. Processors already receive a 21 cent per hundredweight incentive due to the Class 1 differential.

Furthermore, producers already pay a fortification allowance on condensed skim. LOL is now asking producers to also pay hauling costs. We have been told that southern California has plenty of condensed skim capacity. There is no justification to cover the costs of hauling to the southern California market. This is far beyond the original intent of the transportation incentive system developed in California.

Additionally, if, in fact, the MPC proposal also covers condensed skim that is used for Class 1 purposes, we would disagree with that as well.

Thank you for the opportunity to testify, and request the option to submit a post-hearing brief.

HEARING OFFICER ESTES: Do we have any panel questions?

SENIOR AGRICULTURAL ECONOMIST ERBA: Let me see if I can summarize your testimony.

You are not in support of either the petition nor the alternative proposal?

MS. LaMENDOLA: Yeah, I think that would probably summarizes it.

SENIOR AGRICULTURAL ECONOMIST ERBA: Thank you.

You would have preferred I'd just said that?

SENIOR AGRICULTURAL ECONOMIST ERBA: That would be up to you.

HEARING OFFICER ESTES: Any other questions?

Thank you for your testimony today.

We'll take a five-minute break.

(Thereupon a recess was taken.)

HEARING OFFICER ESTES: Okay. We will reconvene at this time.

Our next witness is Jim Dolan from Driftwood Dairy of El Monte, California.

Mr. Dolan, could you please state your name and spell your last name for the record.

MR. DOLAN: My name is James Dolan D-o-l-a-n.

HEARING OFFICER ESTES: And could you identify the organize that you represent.

MR. DOLAN: Organization is Driftwood Dairy.

HEARING OFFICER ESTES: And the process by which you developed your testimony and had it approved for presentation here today.

MR. DOLAN: I did it personally and also with some industry experts.

(Thereupon the witness was sworn, by the hearing officer, to tell the truth and nothing but the truth.)

MR. DOLAN: Yes, I do.

HEARING OFFICER ESTES: Would you like to have your written statement introduced in the record as an exhibit?

MR. DOLAN: Please.

HEARING OFFICER ESTES: I will introduce it as Exhibit Number 70.

(Thereupon the above-referenced document was marked by the hearing officer as Exhibit 70.)

HEARING OFFICER ESTES: So please proceed with your testimony.

MR. DOLAN: My name is James Dolan and I represent Driftwood Dairy in El Monte, California. We have historically purchased a good percentage of our milk from the Southern San Joaquin Valley, up until the time the Southern California Marketing Association was formed.

At that time, little milk was available outside the association, so we began to purchase milk from them at a large premium price. The Marketing Association subsequently partially disbanded and our previous supplier left the Association. We then had to rely on local suppliers and found it to be unreliable as to the promised arrival times and source. Upon completion of our obligation with the Association, we reestablished our relationship with our supplier in the South San Joaquin

Valley.

There has been in the past a disincentive to buy milk plant to plant from the South valley. As most of you remember, I have constantly testified against this disincentive as being discriminatory against ourselves and Swiss Dairy, and I'm here to do it again.

The Chino Basin milk supply is decreasing, while the overall demand increases. Approximately half the cows that were milked in the area during the its prime time have moved elsewhere. Also, there is a large local cheese plant that can absorb most of the milk made available to it. And production of the southern California basin is continuing to decline at an ever-increasing rate.

Studies have been made that shows that plant-to-plant movement of milk from South Valley to southern California is just as efficient, if not more so, than ranch to plant from the valley. It allows you to move milk in components like skim needed for the market without having to haul all the unwanted fat.

Land O' Lakes is asking for an increase in the transportation credit and to extend transportation credits to condensed skim. We support their testimony completely. The only need for condensed skim is to meet California standards, and presently there is only one supplier that can supply condensed skim to southern California.

We have been through a period where local supply is tightly controlled, and I don't care to do it again. We purchase our South Valley milk in Tulare at South Valley prices and must be able to move it to southern California at no disincentive if we are to continue to compete as a viable member of the California supply chain.

The current system does not do that. The haul rate from Tulare to our plant is current 93 cents a hundredweight and the transportation credit is only 50 cents, and the area differential is 27 cents per hundredweight. We cannot compete with a 16 cent per hundredweight shortfall. Historically, the Department has always adjusted transportation credits to allow our plant to compete. That did not happen two years ago.

We feel the pool is responsible to see that milk moves to the fluid market in a manner that allows equal raw product costs under equal terms. Increasing transportation credits to eliminate disincentives to move from South Valley to southern California will help ensure the adequate and timely supply for the southern California fluid market.

Thank you for allowing me to testify today. And I'd like the opportunity to submit a brief.

HEARING OFFICER ESTES: Okay. Certainly you may do so.

Do we have any panel questions for Mr. Dolan?
All right. Seeing none, thank you for your testimony here today.
Our next witness is Francis Pacheco of DFA.
Mr. Pacheco, would you please state your name and spell your last name for the record.
MR. PACHECO: Francis Pacheco P-a-c-h-e-c-o.
HEARING OFFICER ESTES: And could you please -- let me start with the oath.
(Thereupon the witness was sworn, by the hearing officer, to tell the truth and nothing but the truth.)
MR. PACHECO: I do.
HEARING OFFICER ESTES: Could you describe the organization that you represent and how you have developed your testimony and had it approved for presentation here today.
MR. PACHECO: Sure. The organization I represent today, I'm representing Dairy Farmers of America Western Area Council. The testimony that I will be giving was approved by the Executive Committee of the Western Area Council.
HEARING OFFICER ESTES: Okay. So please proceed with your testimony.
MR. PACHECO: It will be short. There is just a

couple points here.

We do support the concept that was alluded to in the CDI's testimony for the northern California increase of 4 cents. We'd like to go ahead and expand on that to include the Solano County as well. And we will give details in that in the post-hearing brief that we would like to submit.

HEARING OFFICER ESTES: Okay.

MR. PACHECO: And a lot of the other items that pertain to this hearing would be also included in our post-hearing brief.

HEARING OFFICER ESTES: Okay. Did you have anything else you wanted to present at this time?

MR. PACHECO: It will all be put into the post-hearing brief.

If there's any questions, I'll go ahead.

HEARING OFFICER ESTES: Do we have any questions for him?

SENIOR AGRICULTURAL ECONOMIST ERBA: Do you propose that those increases to obtain the 4 cents per hundredweight as CDI proposed in the same area?

MR. PACHECO: Pretty much along the same geographic area. And so even though the rates are a little different, when you look at the distances that the milk is moving, the percentages on the tiered scale of mileage, you'll see that the 4 cents -- actually it's still a shortfall. The 4 cents do not cover the shortfall. And we will provide the letter from the haulers as what are the costs in that area.

SENIOR AGRICULTURAL ECONOMIST ERBA: I'd appreciate that. Thank you.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: Mr. Pacheco, you indicated your testimony was approved by the Board. That is, did they just give you a blanket approval to testify to anything? Or was there something specific presented to them to approve?

MR. PACHECO: What they did approve was the concept of increasing the northern California transportation allowance.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE:

Okay. You indicated that there was going to be some other points that were discussed here today that will be addressed in your post-hearing brief.

MR. PACHECO: Correct.

MILK POOLING RESEARCH MANAGER SHIPPELHOUTE: Any idea what points you might raise or anything that your organization supports that the other folks haven't testified to as of yet?

MR. PACHECO: At this time I cannot answer that question. But it will be all listed in our post-hearing brief.

HEARING OFFICER ESTES: Any additional questions?

Thank you for your testimony here today.

MR. PACHECO: Thank you.

HEARING OFFICER ESTES: Our next witness is Sharon Hale of Crystal Cream and Butter Company.

MR. VANDEN HEUVEL: Mr. Hearing Officer, I have a point of order.

The purpose of the post-hearing brief as I understand it is to expand or clarify testimony. And I'm just curious as to -- I mean if this is a technique where we can reserve other controversial things and then kind of pop them into the post-hearing brief, not make any waves at the hearing, not give anybody else any opportunity to ask questions or to listen, and then kind of lay out testimony in a post-hearing brief, it seems a little bit -- that there ought to be some guidance from the hearing officer as to what the purpose of the post-hearing brief is and some reminder to the industry that the primary testimony ought to come into the hearing.

HEARING OFFICER ESTES: Well, certainly that is the case. But at this point I don't -- it's a little bit speculative what the content of that brief will be. And certainly the Department -- the panel is fully capable of being able to sift through whatever is put into a post-hearing brief and discriminate between what is appropriate in post-hearing brief material and what is not.

So I think it would be inappropriate to deny someone the opportunity in full to submit a post-hearing brief. It's done -- I think it's a more appropriate course of action to allow the panel to evaluate the brief in the context of what they presented in their testimony during the hearing and what they may be responding to from other people. So I think the panel is perfectly capable of fulfilling that duty responsibly.

All right. Ms. Hale.

Ms. Hale, would you please state your name and spell your last name for the record.

MS. HALE: Sharon Hale H-a-l-e.

(Thereupon the witness was sworn, by the hearing officer, to tell the truth and nothing but the truth.)

MS. HALE: Yes, I do.

HEARING OFFICER ESTES: Could you please describe the organization that you represent and the manner by which your testimony was developed and approved for submission today.

MS. HALE: We're a proprietary company, family owned. I developed, wrote the testimony, and it was approved by our president.

HEARING OFFICER ESTES: Okay. Would you like your written statement introduced in the record as an exhibit?

MS. HALE: Yes, I would.

HEARING OFFICER ESTES: Okay. It will be introduced in the record as Exhibit Number 71.

(Thereupon the above-referenced document was marked by the hearing officer as Exhibit 71.)

HEARING OFFICER ESTES: And please proceed with your testimony.

MS. HALE: Mr. Hearing Officer and members of the panel: My name is Sharon Hale and I'm Vice President, Dairy Policy and Procurement for Crystal Cream and Butter Company. Our administrative offices are located at 1013 D Street, Sacramento, California. We operate three production facilities in Sacramento that produce a full line of fluid, cultured, and frozen dairy products as well as butter. Crystal, along with its wholly owned subsidiary, McColl's Corporation, distribute dairy products throughout northern California and into Nevada.

Crystal is a member of the Dairy Institute of California and supports the testimony given early by Dr. Schiek. My comments will focus on the proposed changes to the transportation allowance system as they relate to our situation in northern California.

Historical Perspective:

The California dairy industry is fast approaching 34 years of operation under a system we all know as milk pooling. To the majority of participants active in the industry today, it's the only system we've actually experienced. Whatever happened before has been handed down to many of us through word of mouth. My understanding of "life before pooling" is an aggregation of bits and pieces that I've heard through the years, and, unfortunately, I've forgotten much of that. So forgive my gross oversimplification in characterizing pre-pooling as a time of producer "haves" and "have nots." The "haves" shipped to higher usage plants located primarily in metropolitan areas, while the "have nots" shipped to country manufacturing plants with the lower priced usage. Throw in a few unscrupulous handlers and even life as a "have" may not have been that great. This set the tone for perhaps the greatest compromise in the history of the California Dairy -- the enactment of the Gonsalves Milk Pooling Act and development of the first Pooling Plan, a part of which is under review today.

It was adoption of pooling that severed the direct price connection between plant and its milk supply.

With sales dollars from all plants pooled and divided amongst producers throughout the state, individual processors lost the ability to attract milk based on their own unique usage. Absent extraneous forces such as contractual arrangements or capacity issues, it was expected that under pooling producers would seek the closest and least expensive haul regardless of what products were processed in those plants. And in the late 60's most of the closest were manufacturing plants and not those processing the higher usages, which tended to be in or close to population centers.

In recognition of the need to serve the market, the crafters of pooling incorporated an alternative milk movement system. A series of incentives and/or disincentives known as location differentials were adopted to encourage the milk to move from supply areas to deficit areas. Tied to quota milk, location differentials were designed to offset the cost of higher priced hauls to distant markets. As I recall, the rates varied by area, thus allowing specific market conditions to be addressed. Depending on the situation, rates could be set to attract milk to a specific plant with an incentive, discourage milk from remaining in the country with a disincentive, or create a neutral zone whereby the producer was indifferent as to which plant their milk moved.

The constant growth of overbase production in the state caused the location differential system to fail in the early 80's. Affecting just quota milk, location differentials could no longer be reasonably adjusted to assure that higher usage markets were being served. As a replacement, the current system of transportation allowances and regional quota adjusters was developed, giving a partial offset to the cost of moving both quota and overbase milk to deficit markets. But a basic tenet from the original pooling plan was retained. Quota milk carries the financial obligation of moving milk. Transportation allowances are paid to producers who supply milk to qualifying plants within deficit areas, the cost of which is deducted from the pool of quota dollars. To help offset that cost and address equity issues between producers, a series of deductions against an individual's quota shipments known as Regional Quota Adjusters was incorporated at the same time.

Milk Producers Council alternative proposal:

We believe the alternative proposal submitted for this hearing by Milk Producers Council to be substantially the same as the one they submitted for the 2001 milk movement hearing. We testified at the time as to our concerns with their proposal and, unfortunately, see those same provisions in the proposal before us today. We differ from MPC in our view of transportation allowances and would like to elaborate.

Crystal does not view the current transportation allowance system as a, quote, "reward for serving the Class 1 market," end quote. If it were, all producers whose milk is used to make Class 1 products would have received a payment for the last ten years. Instead it was designed to address milk movement problems in locations where they exist. Plants located in deficit supply areas where milk volumes are insufficient as compared to their Class 1, 2, and 3 needs have been included in the system. Plants located within adequate to abundant supply areas have not. The distinction has been whether or not a plant is disadvantaged in its ability to attract milk because of its location vis-a-vis its milk supply. Interestingly enough, Dairy Institute floated an idea a couple years ago to create a Class 1 reward system, but were met with significant producer opposition. We would certainly be open to discussing an idea of that type again, but do not believe it is a replacement for the transportation allowance system presently in effect.

MPC proposal seems to limit coverage to only that amount of milk utilized for Class 1 purposes. This is a departure from both the current and prior milk movement systems and one we feel to be problematic and unjustified.

The current system qualifies plants on a rolling 12-month basis. If the processor meets the criteria for Class 1, 2, and 3, all higher valued usages, producers know they will receive the stated transportation allowance for ail milk they ship to that plant. This allows the producer the opportunity to assess his or her options relative to where they ship their milk. They can compare haul rates minus any offsets coming in the form of transportation allowances and use this information in choosing a buyer for their milk.

The MPC proposal would remove this ability. On an absolute usage basis transportation allowances would vary monthly depending on plant usage and not be known until after the close of the month. In an operation such as Crystal's, usage fluctuates throughout the year based on product demand. Competitive issues, seasonality, consumer consume buying patterns, private label business, they all have an impact on usage. A good example is school business. Crystal supplies a great many school districts with fluid milk, but their needs cycle over the course of a year. Just now most schools are closing down for the summer, forcing milk into lower usages until classes resume in the fall. Fortunately summer usually means a jump in ice cream sales making way for increased use of butterfat and condensed skim. Under the current transportation allowance system, Class 3 usage is included in the usage criteria and producers are unaffected by these fluctuations relative to transportation allowances. Under MPC's proposal, producers will see their transportation allowance drop during the summer months.

In addition, most schools order 1 percent milk, but dairy farms generally supply 3.6 percent butterfat or higher. As I understand it, the unneeded butterfat would not be considered Class 1 under Milk Producers Council's proposal and would therefore reduce the effective transportation allowance as it drops to a lower class for processing. This would actually be a problem with the entire Class 1 category since butterfat usage is not close to 3.6 percent of incoming raw milk. Rare would be the processor who could use all the components from ranch-to-plant milk in Class 1 products.

We believe variable transportation allowances will prove insufficient to attract an adequate amount of milk during the peak times. Therefore, just like the problem the industry faced with location differentials, transportation allowances will need to be set higher than necessary to supply the market on a year round basis. Additionally, we believe this variability will have a greater adverse effect on the independent producers than those shipping to cooperatives, because blending can be used to offset the impact of fluctuations in transportation allowances under the cooperative structure. Crystal may well have the oldest independent producer/processor relationships in the state and we strenuously oppose the adoption of a milk moving plant that favors cooperative over independent supply arrangements.

While on the subject of independent producers, the proposed amendment to Section 921 of the Pooling Plan removes the definition of, quote, "a plant" as, quote, "one or more plants under single ownership within a designated area." Without the ability to combine Crystal's usage, we haven't the slightest idea how to fairly treat independent dairies under MPC's proposal. It seems we would almost be back to pre-pooling days. Not only would we be allowed, but actually obligated to choose which producer went to which plant. Certainly the fluid plant would be the most attractive to a producer, but not all of our milk is needed at that plant. Crystal has no interest in being placed in the situation of finding out just how valuable 10 or 15 cents is to a producer.

Current conditions:

As I mentioned earlier, the concept of deficit supply areas relative to Class 1, 2, and 3 usage has always played an integral part in the milk movement systems under pooling. We believe this concept is still valid and should continue as one of the criteria upon which transportation allowances are based. We certainly believe Sacramento continues to fit the classic definition of a deficit area. Included in Crystal's testimony at the 2001 hearing were population changes between 1990 and 2000 for Sacramento and Placer counties. At the time Sacramento was up 17.5 percent. The most recent data from the California Department of Finance shows Sacramento County having risen another 2.9 percent up to 1,258,600 on January 1st of 2001. That's the most recent data. Placer grew 43.8 percent between 1990 and 2000, adding another 3.7 percent by 1/1/01. All other surrounding counties grown as well.

Specifically the growth in Sacramento County has adversely affected agriculture, including milk production formerly available to Crystal. Information contained in CDFA's Exhibit 35, the Dairy Information Bulletin, and Exhibit 36, California Dairy Statistics Annual, show both market milk and total milk production peaked in 2000. By 2002 market milk production in Sacramento County was down 4.7 percent. Already in 2003 we are aware of two dairies that have gone out of business. The largest at approximately 4,000 gallons per day was consumed by urban sprawl. Galt, formally a small south Sacramento County town surrounded by dairies, has more than doubled in its population over the same 11 years and it's pressing up against several dairies. It won't be long before some of those are forced to sell out or move. As this occurs, Crystal will have no choice but to pull milk from further distances to meet our needs.

The Department's Exhibits 32, which includes ranch-to-plant hauling rates, January 1999 to 2 March 2003, shows local hauls in the Sacramento and San Joaquin area at 30.9 cents per hundredweight in March 2003. Effective April 1, 2003, producers shipping Crystal received a haul weight increase of 1 1/2 cents per hundredweight, making their current average haul rate 32.4 cents per hundredweight. The haul in the northern San Joaquin Valley is listed at 32.1 cents per hundredweight for 3 mills less. And I had heard a major cheese -- I had heard that a major cheese facility located in northern San Joaquin Valley had also experienced a large haul rate increase and was told by company personnel their increase was in effect in March 2003 and therefore should be reflected in the rates listed in Exhibit 32.

This information indicates that the rate structure is virtually the same for producers in Sacramento and San Joaquin Counties, whether they ship their milk locally or ship their milk south for processing. Transportation allowances for Sacramento are currently 9 cents per hundredweight for zero to 59 miles, 12 cents per hundredweight for milk located over 59 miles. Despite what should be an inducement for close in milk to move to Sacramento, milk has actually moved in the opposite direction as growing cooperative and independent manufacturing facilities have been able to provide more attractive premium packages than Crystal. This becomes more of an issue as milk concentrates in a fewer but larger dairies. Where three separate farmers might make three different decisions as to where to ship that milk, one dairy farmer will choose one, thereby losing the other -- leaving the other two processors searching for a supply.

Crystal did not seek an increase in the transportation allowances at this hearing, but do feel conditions easily support maintenance of the current rates and qualifying criteria. Any diminishment in the effective transportation allowance into Sacramento would likely result in the direct increase in the premiums we already pay to retain milk. We have had no choice but to pay competitive premiums since the late 1980's and are concerned about bearing any more of the financial burdens associated with drawing milk into an increasingly deficit area.

Conclusion:

We do appreciate MPC's attempt to simplify a terribly complicated and confusing system. The equity issues stemming from pre-pooling's class price days have rolled forward through location differentials and into RQAs, making it very difficult to separate milk movement plans from concessions and agreements involving producer equity. But MPC's proposal causes us to form an analogy to a system of handler payments based on paying for milk solely by the pound. Forget butterfat and solids-not-fat, just stay on hundredweights received. This would be quite simple and we would all save money by eliminating component testing, but we fear ignoring individual conditions would help some, harm others, and in the end not serve the industry well, our exact assessment of MPC's proposal. We do not believe their proposal represents an improvement over the current system and urge that it not be adopted as a result of this hearing.

Thank you for allowing me to express the views of my company. And I would ask for the opportunity to file a brief.

HEARING OFFICER ESTES: All right. Yes, you may certainly do so.

MS. HALE: Thank you.

HEARING OFFICER ESTES: Do we have any panel questions for Ms. Hale?

SENIOR AGRICULTURAL ECONOMIST ERBA: I have one question.

Ms. Hale, it sounds like based on your testimony, you may have a basis for requesting an increase in the transportation allowances in your area, based not only on the premium that you've had to pay but increases in costs of hauling that others testified to. So why did you choose not to request an increase in those rates?

MS. HALE: We may in fact have a case for that. It's hard to say. Part of the problem was the data that goes into making those decisions in fact comes out and came out at the pre-hearing workshop.

The timing of trying to develop a proposal, get industry support for that proposal and bring it forward, we didn't have the time to do that.

Just having heard that DFA has an interest in changing allowances in northern California, we have no opportunity whatsoever to see what that sort of proposal would do from a competitive standpoint on milk. Basically, you know, we've been content with the situation as it has been. As conditions change around this, we may not be. But at this point in time we weren't able to utilize the information to decide whether or not we needed to make a change.

SENIOR AGRICULTURAL ECONOMIST ERBA: Are you considering submitting something in a post-hearing brief that might request higher rates for the Sacramento receiving area?

MS. HALE: I don't think so, because I don't think that that's proper.

SENIOR AGRICULTURAL ECONOMIST ERBA: Thank you.

AGRICULTURE ECONOMIST GOSSARD: A follow-up question.

From a competitive condition, are you concerned about the CDI proposal for forcing increase in their rates and in the Bay Area?

MS. HALE: That's a part of my concern, and that's information that just came out today. And I don't believe that the way the hearing process has been working that those -- both CDI and DFA, those are surprising new entrants -- late entrants to this hearing.

AGRICULTURE ECONOMIST GOSSARD: I have a couple of questions that come directly -- result directly from your testimony.

On the top of page 3, you state that one of the basic principles is the distinction has been made whether or not a plant is disadvantaged in its ability to attract milk because of its location vis-a-vis its milk supply. You said you supported the Dairy Institute's testimony and they supported the LOL proposal to add Riverside as a receiving area for transportation allowances.

Do you think that the conditions at Riverside have changed enough over time to justify that?

MS. HALE: It's a good thing I'm under oath because I can tell you that I have no idea what goes on in southern California. I have no basis for determining whether or not what has been testified to in the basis of -- where milk moves or where those plants are located, I have no idea whether that does or does not make sense or equates to our situation here in northern California.

AGRICULTURE ECONOMIST GOSSARD: My other question revolves around the issue you brought up that under the MPC proposal the Belvedere plant would be eligible for allowances, but the E Street plant would not. Is that correct and to the frozen --

MS. HALE: That's what I understand.

AGRICULTURE ECONOMIST GOSSARD: Under that proposal, wouldn't you generate the most transportation allowances by generating having the most distant milk come to the Belvedere plant and having the more local milk come to the other plants?

MS. HALE: I would suspect so. But that goes back to my testimony in that we don't want to be placed in a position of having to decide winners and losers amongst our producers. But certainly if a proposal was adopted that required us to do that, we would have no choice but to look at which plant received transportation allowances, which plant did not, and which of the milk needed I guess the greatest protection.

AGRICULTURE ECONOMIST GOSSARD: Okay. No further questions.

DAIRY MARKETING BRANCH CHIEF IKARI: I just have a question.

You testified about the variable transportation allowance an then in the closing of that paragraph you indicated that Crystal is the oldest independent producer processor relationship.

Can I assume from the text of those comments that transportation allowances facilitate a relationship of independent producers to a processor?

MS. HALE: I believe they have allowed us to maintain a relationship. We have not been at this point in time forced to go to into another supplier arrangement based on regulatory activities.

DAIRY MARKETING BRANCH CHIEF IKARI: Realizing that you don't have a southern California -- but couldn't you project that if transportation allowances were granted in southern California, that the same philosophy would hold and the processing plants would be able to get independent producers easier than they can currently?

MS. HALE: Perhaps. But what I do know about independent producers, there are fewer and fewer left in the state. And once you become a cooperative member or owner, it's very difficult to break away from that because of your investments in that whole organization.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. Thank you.

HEARING OFFICER ESTES: Are there any other questions?

Thank you for testifying today.

MS. HALE: Thank you.

Are there any other -- anyone else who wants to testify today?

Having received no additional requests to give testimony, this hearing is closed with the exception of those witnesses who requested to receive the opportunity to file post-hearing briefs.

And please note that the brief must be received by 5 p.m., June 11, as stated earlier today, which is one week from today.

(Thereupon the Department of Food and
Agriculture Milk Marketing Hearing
adjourned at 3:05 p.m.)

CERTIFICATE OF REPORTER

I, JAMES F. PETERS, a Certified Shorthand Reporter of the State of California, and Registered Professional Reporter, do hereby certify:

That I am a disinterested person herein; that the foregoing California Department of Food and Agriculture, Milk Marketing Hearing was reported in shorthand by me, James F. Peters, a Certified Shorthand Reporter of the State of California, and thereafter transcribed into typewriting.

I further certify that I am not of counsel or attorney for any of the parties to said hearing nor in any way interested in the outcome of said hearing.

IN WITNESS WHEREOF, I have hereunto set my hand this 9th day of June, 2003.

JAMES F. PETERS, CSR, RPR
Certified Shorthand Reporter
License No. 10063